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ABSTRACT

In connection with its jurisdiction over biomedical research and development at higher education institutions, the House Committee on Energy and Commerce's Subcommittee on Oversight and Investigations met twice to hear testimony on abuses in the indirect cost recovery practices at universities for Federal research grants and contracts. At the first hearing witnesses testified about the legitimacy and reasonableness of Stanford University's overhead charges and the adequacy of government oversight provided by the Office of Naval Research. The hearing revealed extensive abuses at the university and ineffective oversight from the Navy. Appearing were witnesses representing the Office of Naval Research, the General Accounting Office, Stanford University, and the Defense Contract Audit Agency. Two months later the committee met again to hear suggestions for changing the regulatory and staffing practices of audit agencies, and to hear about the status of audits initiated shortly after the first hearing at the 41 universities that the Office of Naval Research oversees. Appearing were witnesses representing the Department of Health and Human Services (HHS), the Office of Grant and Contract Financial Management, the Inspector General, Office of Naval Research, and the Defense Contract Audit Agency. Included are the prepared statements of the witnesses, an HHS report, "Federal Funding to Colleges and Universities in Support of Research" and various documents and letters from Stanford University. (JB)

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FINANCIAL RESPONSIBILITY AT UNIVERSITIES

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON
ENERGY AND COMMERCE
HOUSE OF REPRESENTATIVES

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

ON

INDIRECT COST RECOVERY PRACTICES AT U.S. UNIVERSITIES FOR FEDERAL RESEARCH GRANTS AND CONTRACTS

MARCH 13 AND MAY 9, 1991

Serial No. 102-33

Printed for the use of the Committee on Energy and Commerce

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FINANCIAL RESPONSIBILITY AT UNIVERSITIES

WEDNESDAY, MARCH 13, 1991

House of Representatives,
Committee on Energy and Commerce,
Subcommittee on Oversight and Investigations,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2123, Rayburn House Office Building, Hon. John D. Dingell (chairman) presiding.

Mr. **Dingell**. The Subcommittee on Oversight and Investigations will come to order.

Under the Rules of the House of Representatives, the Subcommittee on Energy and Commerce has specific jurisdiction over biomedical research and development. This includes research activities at universities like Stanford. What we are going to hear today is a story of taxpayers' dollars going to bloated overhead rather than to scientific research. It is a story of excess and it is a story of arrogance. It is compounded regrettably by lax Government oversight. The Government simply did not do its job. It also encouraged events which bring discredit upon many who under a different milieu might have performed better.

The Chair wants to make it clear at the outset what it is that we focus on today and what are the purposes of the investigation. Today it will be the purpose of the committee to examine the allowability and reasonableness of Stanford's overhead charges to the Federal Government for scientific research. Today the subcommittee will be examining the adequacy of Government oversight provided by the Office of Naval Research, which has the responsibility of protecting the interests of the taxpayers at Stanford University and at other colleges and universities around the country. At a time later we will also be inquiring into similar events at other colleges and universities. In like fashion, we will be scrutinizing the behavior of the auditing functions and the auditing arms of the Department of Health and Human Services to ascertain what it is that they have been doing with regard to their responsibility over public moneys.

The Chair wants it clear that the subcommittee is not examining Government research policy. The subcommittee is not examining the Government's policy towards upgrading university research infrastructure. These are legitimate and proper policy issues. They should be addressed by a number of legislative subcommittees and committees in the Congress and we will try and form a report which will in some degree at least make it clear that we have not engaged in that scrutiny here.

This investigation is not an attack upon science, as is charged by some in the scientific community. This subcommittee has along with its parent committee an unparalleled record of support for Federal funding for research but we have not supported the payment for luxuries masquerading as overhead.

The Federal Government funds tens of billions of dollars in scientific research. We believe that those dollars are and have the capacity for being excellent expenditures of public money. Much of those fundings are biomedical and at major universities and the expenditures both collectively and individually are very large and I believe deservedly so. A major element of the research funding is the indirect costs charged to the Government. Indirect costs are expenses such as administrative costs, utilities, building maintenance, and other matters properly related to research. These are items that cannot be easily or directly associated with a particular research project. They are, however, nonetheless important questions and important matters for support by the Federal Government to ensure that the universities are able to carry out their proper responsibilities.

If the Government funds a research project, for example, at $100,000 and the overhead rate is fixed at 70 percent, the total cost of the project then is $170,000. Overhead rates have been increasing sharply. Some universities charge around 80 percent. Others like Harvard Medical School are closing in on 100 percent. Complaints about these rates have been registered, both by the Federal granting agencies as well as research scientists who find it difficult to compete for research money while saddled with high overhead costs, and the Chair notes that the pressure on responsible scientific research in this country from cuts in budgetary support, inflation, cost increases, and other similar problems are impacting in enormously adverse ways on research, researchers, and scientific knowledge in this country.

It is therefore important to understand that when a university mischarges or overcharges the Government for indirect costs, that it has the effect not only of adversely impacting upon the taxpayers and the expenditures of public moneys generally and the confidence of the people in their Government but it also has the very large and extremely unwanted effect of diverting Federal money directly from other high priority research projects that could have been funded with money that has been squandered in a way not keeping with public policy or the public interest. In other words, when yachts, wedding receptions, antique furniture and flowers are improperly or possibly illegally charged to overhead on scientific research, a number of deserving research projects are simply not funded. Science, the country, and our competitiveness are therefore much the poorer.

In 1984 and 1985 this subcommittee conducted several investigations and hearings on the outrageous overhead charges to the Government by a number of major Defense contractors including General Dynamics. In that instance we found executives charging the Federal Government and taxpayers for dog-boarding and an abundance of other abuses. That taxpayer-funded investigation also saved the taxpayers over $1 billion in unreasonable and fraudulent overcharges. Defense industry overcharges resulted from a combination of contractors gaming the system with a "catch me if you can" attitude and a lack of Government oversight bordering on misfeasance and malfeasance.

In the beginning of this investigation, the subcommittee had reason to believe that we had the same ingredients for disaster. The Chair announces with regret that our worst fears appear to be coming true. The subcommittee chose Stanford as the subcommittee's first case study because of the combination of high overheads and complaints of the faculty about that rate.

The subcommittee investigation began when it received allegations of substantial overcharging at Stanford. In checking into these allegations we learned that Mr. Paul Biddle, the Navy's Administrative Contracting Officer at Stanford, had been fighting an extraordinarily lonely battle for months with his own intransigent Navy bureaucracy to expose a situation at Stanford which was very clearly out of control. Mr. Biddle deserves enormous credit for exposing not only the situation at Stanford, which I believe will save the taxpayers tens of millions of dollars, but for exposing problems which I am confident will lead to similar savings across the country at other institutions. The General Accounting Office [GAO] and Defense Contract Audit Agency [DCAA] auditors also deserve credit for the splendid work which they have done in bringing this sorry situation to light.

The Chair wishes to digress briefly to make an observation which I hope will be of help to the Navy and that is that this committee has a very special, vigorous and long-standing interest in the well-being of those who assist it and in the well-being of those who testify before it. Having said this, I know that the Navy will not look forward to an appearance here to explain any action taken against Mr. Biddle for his having assisted the committee because the committee intends to have a most vigorous interest in his continued well-being and prosperity and I hope that the Navy will keep those thoughts well in mind as we go forward into this examination and as we move on then into other business.

Throughout the subcommittee's review of this matter, Stanford has exhibited a rather brazen, "catch me if you can" attitude. Indeed, it was one which we found rampant in the Defense industry. When the subcommittee first raised the question as to why the university had charged the taxpayers for a 72-foot luxury yacht outfitted with wood stoves and a jacuzzi, Stanford made a flat denial that it owned such a yacht. A month later Stanford admitted that it owned a yacht but denied charging it to the Government. A month later Stanford admitted that it charged some of the expenses to the Government but claimed an honest error and announced that it was immediately withdrawing its charges.

In the meantime the subcommittee's initial findings suggested that there would be a number of similar mischarges to the Government due to lack of Government and university audits, a situation which I find to be egregious at best. The initial audits reveal that Government research had been charged $6,000 for cedar-lined closets at the President's house, $2,000 each month for flowers in the President's home. Charges were made for refinishing an antique grand piano, the purchase of antiques, and over $1,000 a month for laundry charges at a French laundry. I'm Polish and I have my laundry done at a Chinese laundry.

I would observe that in the midst of growing evidence of mischarging and overcharging Stanford performed an audit and claimed—listen to this—that the Government owed it $13 million. We will have some questions about that.

Dr. Kennedy put out a press release claiming that the costs charged for his house were certainly justified charges for the taxpayers. He observed that they were hard to explain, so he would pull out the charges for the three homes on the campus including his own, the Provost's, and that of his Vice President for Public Relations. The Vice President admitted holding parties prior to football games and having the taxpayers contribute $1,500 worth of liquor but claimed it was justified because he believed a researcher or two might have been at these parties drinking the taxpayers' alcoholic beverages.

What we have learned recently about Stanford has made Secretary Weinberger look rather frugal with his $600 toilet seat. Stanford recently purchased an early 19th Century Italian fruitwood commode. The cost was $1,200 and was subsidized by the taxpayers. The taxpayers also contributed to the enlarging of Dr. Kennedy's bed; $7,000 for sheets for the enlarged bed, and the purchase of Voltaire chairs from Pierre Deux, at $1,500 each, and a pair of George II lead urns at a special price, $1,284. They also charged the taxpayers $400 for flowers which were used in connection with the dedication of the Stanford horse stables.

Now we must look with interest on the views of the trustees, because obviously they have a modest interest in what is going on a the university. We would ask where were they during these events? Well, it turns out that they were enjoying the sufferings and tribulations of a retreat at Stanford Sierra Camp at Lake Tahoe, which cost $45,250 and was again subsidized by the taxpayers of the United States.

In addition, the taxpayers are being asked to pick up a significant portion of the administrative expenses at the elite Stanford Shopping Center.

A typically brazen mischarging is recognized and reflected in the recent findings of the GAO. I am going to quote. GAO says, for example, "we discovered that the O&M costs of the Chancellor's residence, a residence not owned by the university, and parenthetically not on the Stanford Campus, are still being charged to the pool, even though the Chancellor retired in 1968 and died in 1985. From 1986 to 1990 these costs amounted to $218,230, of which the Government paid about $63,931. Because the residence no longer serves in an official capacity, does not benefit research, and is not necessary to the operation of the university, none of the costs should be allocated to research. Stanford officials stated they believed such costs were appropriate, since the agreement was entered into while the chancellor was alive and thus represents an employee benefit."

The university's concern for the chancellor's widow is laudable; charging these expenses to the taxpayer is not.

The mischarging reflects an attitude that may permeate the activities and the attitudes of altogether too many universities dealing with Federal money. That is, again, an unacceptable attitude.

What do any of these charges have to do with the furtherance of federally-funded science, the competitiveness of the United States, the defense of this country or with cures or treatments for dread disease?

Believe me, these are not isolated charges, and they are not limited to the President's home or to other homes on the Stanford campus. These outlandish charges are in every cost pool that has been reviewed.

Stanford has made little effort to pull out these unjustified charges from its bills to the taxpayers. Moreover, in 1987 and 1988, a senior Stanford official testified to the Government, or rather certified to the Government under criminal penalty, that there were no expressly allowable charges in its overhead account.

The GAO and DCAA have found a number of charges in the certified accounts that are expressly unallowable, raising serious question as to criminal liability. Despite repeated requests by DCAA, Stanford has refused to certify its 1989 and 1990 overhead charges to the taxpayers. The GAO has found evidence of Stanford's apparent internal manipulation of charges to circumvent Government regulations on donated silver. Charging administrative expenses for Stanford Shopping Center, alumni functions, public relations and lobbying functions are clearly unallowable.

The Navy Investigative Service is currently investigating several criminal matters relative to Stanford's charging practices as well as the Navy's failure. We will follow those matters with more than a little interest.

A final note. The American Association of Universities, AAU, has had some comments with regard to the matters under consideration by the committee at this time. They have been holding press conferences, claiming the real focus of the subcommittee investigation should be on channeling more taxpayer money to the universities, not a review of overcharges to the taxpayers.

The Chair will observe that this committee has worked very hard to see to it that research is vigorously and adequately supported by the Federal Government. We do not think that it is unreasonable to ask that those expenditures be made for proper purposes, in order that we may get the biggest bang for our scientific buck.

The AAU lobbies in Washington on behalf of the interest of 56 of the countries largest research universities. The Chair noted, with modest interest, that the President of AAU is a former Vice President for Public Relations at Stanford, and is provided with an automobile, an adequate salary and the use of a house estimated to cost about $1 million at Massachusetts Avenue in Washington, DC. We have learned that AAU is supported by contributions from these major research universities. Not surprisingly, Stanford charged its $33,000 annual dues to AAU to Government research.

The good news for the taxpayers today is that a rejuvenated Defense Contract Audit Agency will recommend that Stanford's original request for a 78 percent overhead rate in 1991, which is now down to 70 percent should be reduced to 52 percent; a potential savings to the taxpayers of nearly $30 million in 1991 alone. That is good news. We will look at it with approval; but we will also look to see whether 52 percent is an appropriate level.

The other good news is that the subcommittee, with the help of the GAO, will be examining the overhead charges at a number of other universities. We will inspect universities across the country who engage in Government research. We will review their charges to the Government and we will withdraw unallowable and unreasonable charges before the subcommittee commences its reviews. That will save all of us a great deal of trouble. If not, the Chair notes that they will receive the vigorous and the kindly assistance of this subcommittee and other Government agencies in carrying forward that responsibility.

Mr. DINGELL. The Chair recognizes my dear friend, Mr. Bliley, the ranking Republican member of the subcommittee.

Mr. BLILEY. Mr. Chairman, before I begin my statement, I would like at this time to welcome to our committee, our newest member on this side of the aisle, Fred Upton. Fred represents the 4th District of Michigan. He also serves as Deputy Whip, and I believe he represents the same district that another member of this committee in 1981, until he became director of OMB, David Stockton, represented. So, we're glad to have you Fred. I am sure you will find it most interesting and most challenging.

Mr. DINGELL. Would the gentleman yield?

Mr. BLILEY. I would be happy to yield, Mr. Chairman.

Mr. DINGELL. The Chair would like to express my special pleasure that the gentleman from Michigan, Mr. Upton, has joined this committee and that he will be serving with us on this subcommittee. He is a valued member of our delegation in Michigan, and I look forward to his service here with a great deal of pleasure.

He and I are going to differ on many matters; but I am satisfied that he will be a dedicated and energetic and honorable member of this institution. I am also satisfied that where questions relative to the State of Michigan are involved, there will be no differences between him and the chairman.

The Chair thanks the gentleman.

Mr. BLILEY. Thank you, Mr. Chairman.

For many years this subcommittee has performed a valuable public service by exposing instances of waste, fraud and abuse at the Nation's defense contractors. For example, it has helped to bring to light mismanagement in the B-2 Stealth Bomber Program; defective pricing in the Lockheed C-5 Jet Transport; and difficulties in maintaining adequate readiness in the Army's fleet of Apache helicopters. These activities have helped save many millions of taxpayer dollars.

Today, the subcommittee turns its scrutiny towards another form of Federal spending. The billions of dollars that this Government pours into research performed at universities. Both national defense and quality scientific research are desirable. Federally-sponsored, university-conducted research has produced notable scientific discoveries. But the fact that the goals may be worthy, does not excuse lack of controls and waste of taxpayer money in achieving them. Unhappily, the situation here may not be significantly better than the one at the defense contractors.

Stanford University receives around $240 million per year in research grants from the Federal Government. These payments cover both the direct and indirect costs to Stanford in performing the research. Direct costs are the costs actually incurred in performing the research. Indirect costs are the costs to the institution to maintain the "infrastructure" necessary to support the research performed for the Federal Government. No one challenges the proprietary of Stanford receiving payments for its indirect costs, as long as those indirect costs represent the genuine costs to the university of performing the research.

Unfortunately, that does not appear to have been always true in the case of Stanford. When the present Office of Naval Research Resident Representative at Stanford, Mr. Paul Biddle, began examining the transactions included in the "cost pool" used to calculate indirect costs, he found many items that clearly did not belong there. The most notorious item was depreciation on the yacht owned by Stanford University. Stanford originally denied that depreciation on the yacht had been included in the cost pool, then admitted that yes, indeed it had been. Stanford's explanation that the charge had occurred through an accounting error might be more understandable, had the error that permitted the charging of the cost of the University Sailing Program to the Government not occurred yearly for 8 years.

I am certain, Mr. Chairman, before the day is out, the subcommittee will hear even more horror stories about costs that were included in the indirect cost pool, a portion of which were billed to the taxpayer. It appears that Stanford had virtually no system designed to screen transactions to ensure that inappropriate costs did not appear in the cost pool. To make matters worse, the resident representative prior to Mr. Biddle did not request audits by the Defense Contract Audit Agency, so the Office of Naval Research had little or no idea what Stanford was placing in the cost pool. In fact, instead of scrutinizing Stanford intently, the prior resident representative entered into over 100 Memoranda of Understanding that may have cost the Government many millions of dollars.

While the concept of Memoranda of Understanding is perfectly legal, the fact is that, in the case of Stanford, the MOU's were not supported by the required legal and financial analysis. Most universities operate without any MOU's and the next highest number is eight. Why the inordinate number of MOU's in the case of Stanford, and the lack of financial and legal analysis supporting them did not attract the attention of the headquarters of the Office of Naval Research is something that I intend to find out.

Mr. Chairman, I commend you for holding this hearing to better inform the members of the subcommittee on this situation. I look forward to hearing from our witnesses today.

Mr. DINGELL. The Chair thanks the gentleman. The Chair now recognizes my dear friend, Dr. Rowland.

Mr. ROWLAND. Thank you very much, Mr. Chairman. I commend you for the focus of this hearing.

Mr. Chairman, it is a great deal of concern to me that we do find in our university system, at least one university so far that apparently has abused much of the Federal dollars that came to them that could have been used in research. It also concerns me that there may be diversion of dollars that go into this kind of activity that would go to research.

You have already pointed out that this is not a hearing to any way jeopardize money that goes to research and goes for the scientific activities that need to be carried on by our universities in this country, but rather to uncover those types of activities that might, in fact, be detrimental to that kind of research and activity that so appropriately should be funded by the Federal Government in our country.

That is a summation of my statement, Mr. Chairman.

Mr. **Dingell**. The Chair thanks the gentleman. The Chair recognizes the gentleman from New York, Mr. Lent.

Mr. **Lent**. Thank you, Mr. Chairman. Mr. Chairman, America is committed to advancing the sciences. Since World War II, the Federal Government has entered into arrangements with both public and private universities in which Federal tax dollars are used for the purposes of research and development.

This arrangement benefits both university as well as taxpayer. Institutions receive the funding they need to conduct research, while the taxpayer utilizes existing resources, thereby getting the most for his or her tax dollar. The scenario I just described works perfectly in theory.

The facts that you are about to hear today, however, amply demonstrate the wide gap between theory and practice. Stanford University is one of this Nation's most respected institutes of higher learning. The research conducted there has enabled America to remain at the cutting edge of advancements in science, and for that, Stanford deserves our praise and our thanks.

But Stanford University has performed abysmally when it comes to accounting for the Federal dollars it receives. Its internal audit system was, to all appearances, nonexistent. This lax attitude towards accountability resulted in the reimbursement by the Government of some questionable, and in many cases outright unallowable indirect cost items.

Stanford does not bear this blame alone. The Office of Naval Research has been entrusted with the duty of overseeing the way in which the taxpayers' dollars are being spent in this regard. For the decade of the 1980's at Stanford, ONR's performance was nothing short of pitiful.

Agreements known as MOU's were entered into without benefit of audit or legal advice, both of which are required by regulations. Laissez faire is great when it comes to the marketplace, but it has no place in oversight responsibilities. The cost of this fiasco is, quite frankly, unknown. Auditors are now digging back to 1980 in an effort to reconcile accounts that contain hundreds of millions of dollars and thousands of transactions.

Some say the cost could be as high as $200 million, and while this figure may be disputed, the investigators charged with looking into this matter cannot say whether the actual cost is higher or lower than the $200 million figure.

Mr. Chairman, I want there to be no mistake; I wholeheartedly support research funding for institutions like Stanford. They perform a vital service to our Nation and must be continued, but we have a paramount interest as well, to the American taxpayer, for it is he who ultimately foots the bill. In this case, the taxpayer has unwittingly written a blank check that is cashed year in and year out. We'll be hearing a lot of information today about who did what and how. You'll hear about yachts, cedar closets, cozy relationships and impartiality. But let's not forget the bottom line; in this instance, the taxpayers who are not being properly served.

It's good to know that both Stanford and the Office of Naval Research recognize their failings. But forgive me when I say that it doesn't quite satisfy me, because they should never have occurred in the first place. We have regulations. We have directives that are designed to protect the taxpayer.

If these regulations are not clear, they should be rewritten. If they are not being followed, those persons neglecting their duties should be held accountable. We must take action now to prevent something like this from happening again. Thank you, Mr. Chairman.

Mr. DINGELL. The Chair thanks the gentleman. The Chair recognizes now the gentleman from Oregon, Mr. Wyden.

Mr. WYDEN. Thank you very much, Mr. Chairman. I want to commend you and the staff for an extremely important inquiry and, as you've noted, Mr. Chairman, one that's being pursued in a bipartisan fashion. Today's hearing is important to all the members of the subcommittee, but it does have special significance for me.

I'm a 1971 graduate of Stanford University. My mother works at the Green Library on campus. Witnesses are going to describe Stanford as a great university. I can say that I know firsthand that that's the case. Over the next few hours, the subcommittee is going to receive a primer in the complicated technical rules, the A-21 Circulars, the Memorandums of Understanding, the rules that are employed to calculate how universities are reimbursed for the overhead costs of their research.

But I'd submit that these arcane technical rules aren't the key issue this morning. Every single taxpayer knows the real issue here. Billing the Government for yachts and parties and baubles is wrong. Frittering away scarce Government resources can't be justified under any circumstances and under any interpretation of these rules.

Scientific research is especially important to our country now, for it is the key to our ability to compete in tough global markets and bring the fruits of scientific innovation to our citizens. Some will say that this research will be damaged by tighter controls over indirect research costs. I disagree. Reform is going to mean more dollars can go directly to research rather than yacht depreciation.

This Stanford graduate believes no legitimate scientific inquiry needs to be padded by bills for flowers, antique commodes and french laundry. Scientific initiatives are not going to be derailed by disallowing these charges and everyone in this room knows that that's the case.

It's time for a new accountability over Government research dollars spent on campus. It's time that every researcher whose work is funded by the taxpayer is accountable to those taxpayers. Outstanding scientists and prestigious universities cannot be exempt from this new accountability.

Every university in this country that receives Federal research dollars is going to be watching Stanford today to see how this leading, great university responds to this inquiry. I hope to hear Stanford testify today that they're going to take the lead on behalf of all the universities to plug the holes in the current accounting mess for research costs so the taxpayers' interests are going to be protected.

Mr. Chairman, again I commend you for an important inquiry. I think the Chair is aware that Dr. Kessler of the FDA is upstairs and this member would like to pursue with him some of the issues that we've been touching on as well in Oversight, so it may be necessary to excuse myself for a few moments. I just appreciate the chairman's initiative in this matter.

Mr. **Dingell**. The Chair certainly understands the concerns of the gentleman and will protect him. The Chair recognizes now our new colleague to whom the Chair again expresses welcome, Mr. Upton of Michigan.

Mr. **Upton**. Thank you Mr. Chairman. I welcome the opportunity to serve on this subcommittee during the next 2 years and I appreciate your kind remarks and those of my colleagues as well. Though I do not have an opening statement, I look forward to today's hearing and the participation by the panelists that are here, and I look forward to participating in that debate. Thank you for bringing this to the attention of the American public, Mr. Chairman.

Mr. **Dingell**. The Chair thanks the gentleman. The Chair recognizes now the gentleman from Ohio, Mr. Eckart.

Mr. **Eckart**. I thank the chairman. It should be just a simple observation to us that waste is waste, whether it's clothed in khaki or camouflage, blue jeans or the robes of academia; it's wrong. Being charged with trying to protect the Treasury of the United States, we need to understand that those who would benefit from this research are the first to suffer from its abuse, the scientists all across America who are increasingly pinched by constraints in Federal spending, by, from my perspective, misguided funding of projects such as the superconducting supercollider and the abuse of the accountability of the universities that serve as the trustees of those taxpayer dollars.

I submit that Stanford has seldom enjoyed such national publicity as when they last upset Notre Dame in South Bend. That was much more favorable treatment than they are about to receive today. I hope, however, like that game, Stanford and those problems that are evidenced by this hearing can be seen in an appropriate light from which lessons can be learned, in which those of us who are responsible to the taxpayers for providing the funding for those kinds of projects can go home and say that, yes, there was a winner, and indeed, there was a loser.

Since the prospect of all sports, like this hearing, is to learn the lessons from life, let me also be able to say and hope that winners and losers alike today will be the taxpayers and the universities who will know that our dollars will be better watched, that the projects will be better supervised and that ultimately we all will be winners in the game of science and research.

After all, it is under those terms and circumstances by which this country will be only capable of prospering in the future. I thank the chairman and yield back the balance of my time.

Mr. Dingell. The Chair thanks the gentleman. The gentleman from Minnesota, Mr. Sikorski.

Mr. Sikorski. Thank you, Mr. Chairman.

Mr. Chairman, I, too, want to commend you and the Republican leader and the respective staffs for conducting this investigation and this hearing.

I think everyone has to appreciate the respective responsibilities and obligations of the various entities involved here.

The academic, college, university, scientific, and research communities have to be vigilant, always vigilant, to any attempts to move on academic freedoms, and the fragility of research many times conducted is so technical, so complicated, so in need of being protected from publicity, is a responsibility the academic community has to undertake and guard.

The responsibility of those of us in the Federal Government is equally great. In sum, we have to ensure the taxpayers' dollars are wisely spent.

The end result of both groups performing their responsibilities is that the dollars will find their best use, the dollars will be used well and not wasted, and that the confidence of the citizens who pay these dollars will increase, and their enthusiasm for research will increase and, with it, their commitment in terms of dollars and public support.

Consequently, I think it is all important to embrace these responsibilities with tolerance and fairness, and I am glad that this subcommittee is pursuing its traditions and history and focusing on this area.

I, too, like Congressman Wyden, have responsibilities in H&E, Health and Environment, but—so, I will be bouncing back and forth between that. Again, Mr. Chairman, I want to commend you and the staff for just a top-rate job.

Mr. Dingell. The Chair thanks the gentleman.

The Chair notes that concludes the opening statements.

The Chair now announces that Panel 1 will come forward.

The Chair is very happy to welcome Mr. Milton J. Socolar, Special Assistant to the Comptroller General of the U.S. General Accounting Office.

Mr. Socolar, you have been before us on a number of occasions. We have always found your assistance to the subcommittee to be very valuable, and I am sure you know that you and the General Accounting Office are regarded with a special respect by this subcommittee and by its chairman.

The Chair announces that you are also accompanied by Mr. John Ols—Mr. Ols, we are happy to welcome you—and Ms. Doren Eng. We certainly welcome you both and thank you for your assistance to the committee.

Mr. Socolar, for your assistance, there are copies of the rules of the subcommittee, rules of the committee, and rules of the House. They are present at the committee table to assist you in knowing both of your rights and the limitations on the power of the subcommittee.

The Chair is sure you recall from your earlier appearances here that it is necessary, under the rules, that all witnesses who testify do testify under oath.

The Chair directs this question to you, to Mr. Ols and Ms. Eng, do you or any of you object to appearing here under oath?

Mr. **Socolar**. No objection, Mr. Chairman.

Mr. **Dingell**. The Chair notes that, given that, you are entitled to be advised by counsel during your appearance here. Do any of you desire to be advised by counsel during your appearance here?

Mr. **Socolar**. No, sir.

Mr. **Dingell**. Very well, then, if you will each please rise and raise your right hand.

[Witnesses sworn.]

Mr. **Dingell**. Ladies and gentlemen, the Chair notes for the record that you are now all under oath, and Mr. Socolar, we are happy to recognize you, Mr. Ols, and Ms. Eng for such statements as you wish to give to the committee.

TESTIMONY OF MILTON J. SOCOLAR, SPECIAL ASSISTANT TO THE COMPTROLLER GENERAL, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY JOHN M. OLS, JR., DIRECTOR, RCED, AND DOREN ENG, EVALUATOR-IN-CHARGE

Mr. **Socolar**. Thank you, Mr. Chairman.

I do have a detailed statement which I would appreciate having introduced into the record.

Mr. **Dingell**. Without objection, that full statement will be inserted in the record, and you are recognized for such comments as you choose to give.

Mr. **Socolar**. Thank you.

We are pleased to be here today to discuss our ongoing work looking at how indirect costs are charged to Federally-sponsored research. We began our work at Stanford University in October 1990, and so far, our work has been limited to Stanford.

Since World War II, the Federal Government has been a key supporter of research activities at universities, and its involvement has generally been viewed as beneficial to universities and the Nation as a whole.

Of the $69 billion in planned spending for Federal research and development in fiscal year 1991, it is estimated that about $9.2 billion, or over 13 percent, of all Federal R&D funding will be spent on research activities at colleges and universities.

At Stanford specifically, Federal research funding over the past 10 years has totaled about $1.8 billion, of which over $600 million has been for the payment of indirect costs. Briefly put, I would say that both Stanford and the Government's cognizant Agency, the Office of Naval Research [ONR] failed in their respective responsibilities regarding the proper use of Government funds.

Stanford failed to see to it that only proper charges were made to the Government, and ONR failed in its responsibilities to determine that the bases for charging costs were, in fact, reasonable and justified. If ONR had been more diligent, we might not be here today.

Stanford uses a complicated accounting and allocation system for distributing indirect costs to direct cost objectives. In order to appreciate the issues we are discussing today, it is necessary to understand the distinction between the accounting for direct and indirect cost charges.

Direct costs are those that can be specifically identified with a particular sponsored project, instructional activity, or other institutional activity. For example, the direct costs of research are items such as the salaries of the investigators, project-specific research materials and the like.

On the other hand, indirect costs are those that cannot be identified with a particular project or activity. These would include such costs as utility expenses, depreciation of buildings, and general university administrative costs.

Direct costs are charged directly to the Government, while indirect costs are charged on the basis of their allocation to various university purposes, with an indirect cost allocation to research computed as a percentage of direct research costs.

Until the mid-1960's, Federal reimbursement for indirect costs was limited to 20 percent. In 1966, the limit was removed. By 1990, the average indirect cost rate charged by universities had risen to about 50 percent.

Stanford's rate, which is one of the highest in the country, had risen to 74 percent by 1990. Each percentage increase in Stanford's indirect cost rate equates to over $1 million in additional indirect charges.

In conducting our examination, we identified both unallowable and inappropriate costs that were charged to the Government. In the limited time since we started our work, we were able to identify over $3.6 million of such costs, of which almost $1 million were charged to the Government.

As an example of unallowable costs, Stanford erroneously charged depreciation costs totalling $400,000, of which the Government paid $184,000 for various athletic equipment, such as racing sculls and, in particular, the yacht Victoria.

It also erroneously charged administrative salaries and expenses totalling over $700,000 associated with a shopping center owned and operated by Stanford, of which $185,000 was paid by the Government.

In both of these examples, the costs are unallowable under OMB Circular A-21, because they directly relate to university auxiliary activities and do not in any way benefit research.

In addition, we identified a number of other instances involving smaller dollar amounts which, in our view, were inappropriately charged to research and passed on to the Government.

Inappropriate costs included charges for cedar closet liners and cabinets, floral arrangements, sterling silverware and other silver items for the president's house. Charges for the sterling silver items were particular noteworthy.

These items were appraised at a total value of about $10,000, but the appraisal was made on a piecemeal basis, such as by knives and forks, resulting in items being valued at less than the $500 capital equipment threshold. Stanford used the individual items values as the basis for charging off the total cost of $10,000 in 1 year.

As you know, in January, Stanford agreed to withdraw all general expenses associated with the president's house, as well as with two other University-owned residences. This withdrawal of costs included about $2.2 million charged to the general and administrative cost pool from fiscal years 1981 through 1988, of which the Government paid over $520,000.

Another more general concern relates to the allocation process by which expenses not directly related to research were nevertheless allocated for payment by the Government.

At Stanford, the allocation process is largely driven by 90 active Memorandums of Understanding, or MOU's, as they are referred to, some supported by special studies that provide for alternatives to the prescribed A-21 allocation methodologies.

Despite the implications these agreements have for higher cost allocations to Federal research, they were not subject to either audit or legal review by the Government, as required by Navy regulations.

Additionally, A-21 requires periodic review of the special studies. In our examination of selected MOU's and special studies, we found, among other things, that they were based on unsupported assumptions and did not demonstrate that their methods were more equitable than the methodologies prescribed in A-21.

- The agreements reached between Stanford and the Navy generally resulted in higher allocations of costs to organize research without adequate justification, as required by A-21. The potential cost impact to the Government can be illustrated by an MOU regarding Stanford's methods of calculating and allocating depreciation.

Based on the MOU proposed by Stanford and agreed to by ONR, Stanford used an accelerated method of depreciation for buildings and improvements, rather than the A-21-prescribed straight-line method, even though it has not provided adequate justification for doing so.

By using the accelerated method, Stanford was able to recover $2.3 million more from the Government in depreciation charges in fiscal year 1986 than it would have been allowed under the A-21 standard straight-line method.

While we have not calculated the total dollar impact resulting from using this and other MOU's involving depreciation, the overcharges to the Government could be substantial, since depreciation costs charged to organized research totaled over $13 million in 1986, of which close to $10 million was paid for by the Government.

We analyzed two of Stanford's special studies in detail, the Library Study and the Utility Study. These studies do not conform to A-21 requirements. They were not adequately supported, were not statistically sound, did not distribute costs in accordance with relative benefits derived or were not reviewed every 2 years and updated if necessary, yet these two studies have resulted in an annual charge to the Government of about $11 million over the amount the Government would have been charged had Stanford followed the standard methods established in A-21. These MOU's and the special studies that accompanied them were all accepted and agreed to by ONR representatives without challenge or legal and audit reviews as required.

As I mentioned, these findings demonstrate that both Stanford and ONR failed in their responsibilities to ensure than only proper costs were billed to the Government. Many contributing factors brought this situation about but basically it boils down to inadequate administration by Stanford and lack of proper oversight by ONR over the past decade.

I should add here, as I said at the beginning, that the Government and universities both benefit from Government-sponsored Federal research at universities. However, the parties involved, the Government and the universities, have a responsibility to ensure that only proper charges are billed and paid.

On a more positive note, let me mention the recent initiatives that are taking place by both the Government and Stanford to correct the problems that we and others have identified.

These include examinations by the ONR's Inspector General, establishment of a special ONR team to review all of the MOU's and to work closely with DCAA to complete audits for fiscal years 1981 through 1989 and to actions taken by Stanford in hiring a public accounting firm to assess standard systems and procedures and in establishing a special advisory panel to review and advise on the implementation of improvements identified.

The initiatives that are being undertaken are positive and appropriate steps to bring the problems identified under control. We would be pleased to work with these entities to assist in resolving the problems at Stanford. However, we do believe that we now need to look beyond Stanford to determine whether the problems identified also exist at other universities and, if so, what can and should be done to protect the Government's interests. Among other things there might well be cause for changes to OMB Circular A-21 and an overall examination of the Government's approach for reimbursing indirect costs at universities.

This concludes my statement, Mr. Chairman. I and my colleagues would be pleased to answer any questions that you or other members of the subcommittee may have.

[Testimony resumes on p. 45.]

[The prepared statement and attachments of Mr. Socolar follow:]

United States General Accounting Office

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FEDERALLY SPONSORED RESEARCH
Indirect Costs Charged By Stanford University

Statement of
Milton J. Socolar, Special
Assistant to the Comptroller General

Before the
Subcommittee on Oversight and Investigation
Committee on Energy and Commerce
House of Representatives

GAO/T-RCED-91-18

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our ongoing work looking at how indirect cost, or "overhead" as it is commonly known, is charged to federally sponsored research at universities. So far, our work has been limited to Stanford.

The federal government since World War II has been the key supporter of research activities at universities, and its involvement has been generally viewed as beneficial to the university community as well as to the nation as a whole. Of the $69 billion in planned spending for federal research and development (R&D) in fiscal year 1991, it is estimated that about $9.2 billion--or over 13 percent of all federal R&D funding--will be spent on research activities at U.S. colleges and universities. Despite the positive benefits and the generally good relationships that have developed over the years between the government and the university community, there have been some areas of tension and concern, particularly over rising charges for indirect costs.

At Stanford, we have been looking at the kinds of expenditures included in various indirect cost pools and how indirect costs are allocated to federal grants and contracts through application of an indirect cost rate. (See attachment I for a more detailed description of how costs are allocated to federal research.) Our focus has been on selected accounts and transaction detail for fiscal year 1986, the last year audited by the Defense Contract Audit Agency (DCAA). Our purpose was to determine whether or not costs are accumulated and allocated by Stanford in accordance with the established Office of Management and Budget (OMB) guidelines.

RESULTS IN BRIEF

Overall, we found that serious deficiencies in Stanford's cost allocation and charging practices, combined with inadequate oversight by the Office of Naval Research (ONR) led to significant overcharges to the government. We identified a variety of examples of unallowable and inappropriate costs that Stanford included in its various indirect cost pools charged to federal research in 1986. Although we reviewed only a small portion of the many transactions Stanford processes annually, the examples we found show that the university did not exercise the degree of responsibility one might reasonably have expected, as Stanford officials themselves have recently acknowledged.

The allocation process at Stanford is largely driven by about 90 active Memorandums of Understanding (MOUs), some supported by cost analysis studies or "special studies," between the university and ONR. Some of these MOUs allowed for significant increases in the allocation of indirect costs to federal research without adequate support or review. Our concerns coincide with findings of the Inspector General of the Office of the Chief of Naval Research who recently reported, among other things, that a lack of audit and legal review by ONR and DCAA over these MOUs may have resulted in potentially significant overcharges to the government.

As you know, a number of efforts are underway at Stanford to resolve these concerns. In December, the Chief of Naval Research appointed a special team of senior legal and contract administration staff to review Stanford's accounting and charging practices and to work closely with DCAA and other concerned government agencies in completing audits and negotiations of incurred costs at Stanford for fiscal years 1981 through 1989. Stanford itself has recognized shortcomings in its accounting system and has recently hired an independent public accounting firm to assess its systems and procedures and appointed a special advisory panel to review and advise on the implementation of improvements identified.

BACKGROUND

Over the past 10 years, through fiscal year 1990, Stanford has received about $1.8 billion in federal research contracts and grants (excluding funds for the Stanford Linear Accelerator Center)--including about $605 million to cover indirect costs. To fully appreciate the situation at Stanford, it is necessary to understand the basis upon which university research is funded by the government. Research entails both direct and indirect costs. Direct costs are those that can be specifically identified with a particular sponsored project, instructional activity, or other institutional activity. For example, the direct costs of research are items such as the salaries of the investigators, project-specific research equipment and materials, and the like. On the other hand, indirect costs are those that cannot be identified with a particular project or activity. These would include such costs as utility expenses, depreciation of buildings, and general university administration costs. The actual indirect cost rate charged for research is roughly the total indirect costs allocated to research, divided by total direct research costs less certain exclusions specified by OMB Circular A-21.

Over the years, a great deal of controversy has centered on the indirect costs associated with federally sponsored research at universities. This is due, in part, to the difficulty in determining what costs should be assigned to research, particularly in a university setting where education and research are so closely intertwined and, in part, to the question of how much of the indirect costs should be borne by the government. Until 1966, federal reimbursement of indirect costs was limited to 20 percent of direct costs. At that time, the limit was removed and by 1990, the average indirect cost rate charged by universities had risen to about 50 percent.

Stanford's indirect cost rate has been consistently among the highest of any university in the country. Its rates rose from 58 percent in fiscal year 1980 to 74 percent in fiscal year 1990--which means that for every $100,000 awarded to cover the direct costs of a research project, another $74,000 is added on for indirect costs. For fiscal year 1991, Stanford originally asked for a rate of 78 percent. However, on the basis of questions raised by a number of investigations currently ongoing at Stanford, including GAO's, ONR set a provisional rate[1] of 72 percent in

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[1] Provisional rates are negotiated at Stanford for forward pricing or billing purposes subject to later adjustment based on audits of actual incurred costs.

December 1990. This past February, that rate was further reduced to 70 percent.

OMB Circular A-21 establishes the principles for determining costs applicable to grants and contracts with educational institutions. It defines allowable and unallowable costs and discusses indirect cost pools that should be established for accumulating and allocating such costs to research projects. The tests for allowability require that costs be (1) reasonable, (2) allocable to research projects under the A-21 principles and methods, (3) consistently applied, and (4) in conformance with any limitations or exclusions established by the circular or by individually sponsored agreements as to types or amounts of costs. A-21's definition of "reasonableness" includes determining whether or not the cost is of a type generally recognized as necessary for the operation of the institution, and whether or not individuals responsible for incurring those costs acted with due prudence in the circumstances, considering their responsibilities to the institution, the government, and the public at large.

A-21 also allows universities to perform special studies to justify alternatives to the standard A-21 allocation methodologies. A-21 stipulates that such studies, among other things, (1) must be appropriately documented, (2) must distribute costs to the related cost objectives in accordance with the relative benefits derived, (3) must be statistically sound, and (4) must be reviewed at least every 2 years and updated, if necessary. Stanford currently has four such special studies in place.

EXAMPLES OF UNALLOWABLE AND QUESTIONABLE COSTS CHARGED TO FEDERAL RESEARCH

We identified a number of instances in which costs that are unallowable under A-21 were included in various cost pools, a portion of which was charged to federal research. In addition, we identified other costs which were inappropriate for charging to the government. In the limited time since we started our work, we identified over $3.6 million in unallowable or inappropriate charges, almost $1 million of which was erroneously charged to the government. These include:

- Depreciation costs totaling over $400,000, of which about $184,000 was charged to the government, for various items of athletic department equipment, including several racing sculls and, primarily, the yacht Victoria.
- Salaries and related administrative expenses, totaling over $700,000, associated with a shopping center owned and operated by the university, over $185,000 of which was charged to federal research.

In both of these cases, the costs are clearly unallowable as they directly relate to university auxiliary activities and do not benefit research. In addition, we found a number of other instances of improper charges which are described in attachment II.

Other items we identified as inappropriate for federal reimbursement included charges for cedar closet liners and cabinets, floral arrangements, sterling silverware and other silver items for the President's House, also known as the Hoover House.

Stanford announced in mid-January of this year that it would be withdrawing all the general expenses of the Hoover House, as well two other university-owned residences: the Hanna House (the Provost's residence), and the Lake House (the residence of the Vice-President for Public Affairs). This withdrawal of costs included over $2.2 million charged to the G&A pool from fiscal years 1981 through 1988, of which the government paid over $520,000.

These overcharges resulted because Stanford officials did not carry out their roles and responsibilities in a manner to assure only proper costs were passed on to the government. In this regard, the controller's office either did not review, inadequately reviewed or otherwise allowed unallowable costs to be charged improperly to the government. Also, the accounting controls over indirect cost charges related to federally funded research at Stanford are clearly deficient.

QUESTIONS INVOLVING STANFORD'S ALLOCATION OF COSTS TO FEDERAL RESEARCH

While a selective review of individual transactions can be revealing, it is the allocation process that has the greatest potential for significant overcharges to federal research since it affects all indirect costs. At Stanford, the allocation process is largely driven by various MOUs and special studies, accepted in past years by ONR. Despite the implications these agreements have for higher cost allocations to federal research, however, they have not been subjected to either audit or legal reviews by the government as required by ONR regulations.

We analyzed several key MOUs and special studies that affect cost allocations. We found that some of them include questionable assumptions, do not provide adequate justifications for the allocation methodologies used, as required by A-21, and generally result in higher allocations of costs to organized research than the standard A-21, or so-called "default method," allows. The Department of Health and Human Services (HHS) and DCAA have recently recommended to ONR that all the MOUs at Stanford be terminated, which the Chief of Naval Research said will be decided by April 1.

The potential cost impact to the government resulting from using the MOUs at Stanford can be illustrated by the MOUs regarding Stanford's methods of calculating and allocating depreciation. For example, based on an MOU proposed by Stanford and accepted by ONR, Stanford uses an accelerated method of depreciation for buildings and improvements rather than the A-21 prescribed straight-line method, even though it has not provided adequate justification for doing so. ONR has now recognized this shortcoming and just recently notified Stanford that it could not continue to use this method without justifying it, even though Stanford had been using it, with ONR's approval, as far back as 1961. By using the accelerated method, Stanford was able to recover $2.3 million more from the government in depreciation in 1986 than would have been allowed under the straight-line method.

In another example, ONR agreed to allow Stanford to include in its indirect cost pools the direct costs of certain nongovernment grants and contracts that benefit certain general purpose functions such as the libraries. However, A-21 specifies that the determining factor in distinguishing direct from indirect costs is the ability to identify the costs with a sponsored project, not by the nature of the goods and services involved. By charging the expenses under these grants and contracts to indirect cost pools, Stanford receives full reimbursement under its grants or contracts from non-government sources and additional reimbursement from the government through the indirect cost recovery process. Additional examples of other allocation problems can be found in attachment III.

Special Studies

In addition to the above, Stanford has conducted four special studies in other cost areas to justify using alternatives to the A-21 default methods for allocating costs. Stanford used these studies as the basis for various other MOUs, accepted in past years by ONR, affecting cost allocations to federal research. The two studies we reviewed to date--the library study and the utility study--do not conform with A-21 criteria, and thus do not provide Stanford with a valid basis for allocating costs other than by the default method.

Library Study

Stanford's library study is a case in point. Among other things, A-21 specifies that special studies must allocate costs on the basis of relative benefits derived. However, Stanford allocates most library costs on the basis of "cause and effect". For example, they allocate technical processing costs, which include the costs of the books and preparing the books for use, to all library users except non-Stanford users because they maintain they initially incur the costs for Stanford users only. However, non-Stanford users clearly benefit from the purchase of the books, and therefore should be allocated a portion of these costs. Since costs associated with all users except non-Stanford users are allocated to research, the government pays a higher portion of the library costs than are justified.

To illustrate the potential effect of using the library study, in fiscal year 1988 Stanford allocated library costs of $12.5 million to organized research using the method contained in the special study. According to Stanford's calculations, under the default method, only $5.2 million would have gone to organized research, a difference of over $7 million.

Although ONR announced just last month that it was rejecting the study, the same study has been used, with ONR's approval, for allocating library costs since 1981. Had ONR subjected the study to audit and legal review before approving it, the indirect costs charged to the government might have been lower.

Utility Study

Another special study that has significant impact on how costs at Stanford are allocated to federal research is the utility study. This study, used to allocate the costs of electricity, natural gas, steam, and chilled water, and the maintenance costs of each utility system, was conducted for Stanford by an outside consultant in 1981 with major revisions in 1982. In our opinion, the utility study also does not comply with A-21 criteria, among other things because it is not "statistically sound." Stanford's study included a selection of 10 buildings that were predominantly used for research, out of 18 buildings that happened to have utility meters, and then projected the results to all 660 buildings on campus, to allocate utility costs that, in 1986, totalled over $15 million. While the definition of "statistically sound" may be open to interpretation, we do not believe that 10 out of 660 is a statistically sound sample, and particularly since utility usage varies greatly by building, depending upon such factors as age, condition, type of construction, type of heating system, and so forth.

Although Stanford officials stated that an ONR engineer agreed that the sample buildings were representative of the buildings on campus, our discussion with him revealed that he was primarily concerned with ensuring that research space was adequately represented in the sample. However, since, based on the study, utility costs are allocated to research in proportion to allocations to other cost objectives, such as instruction, he should have also ensured that non-research space was adequately represented as well.

Similar to the library study, ONR has also recently rejected the utility study until and unless Stanford can provide appropriate justification for its use, even though the study has been in use, with ONR's approval, since 1981.

For fiscal year 1988, $8.8 million in utility costs were allocated to organized research. According to Stanford's calculations, utility costs allocated to organized research under the default method would have been approximately $4.7 million, a decrease of $4.1 million for that year.

These allocation examples demonstrate that both Stanford and ONR failed in their responsibilities to protect the proper use of government funds. While Stanford has not demonstrated that their allocation methods are justified, ONR has allowed the university to use such methods for many years without challenge. Had ONR adequately reviewed and challenged these studies when originally proposed, Stanford would have had to either follow the default methods prescribed by A-21 or conducted proper studies to justify any amount more than the default methods allow.

ONGOING EFFORTS AT STANFORD

As a result of all the attention focused on Stanford in recent months, several other inquiries have been launched into various aspects of Stanford's indirect cost recovery practices. One of the first reviews, conducted by the Inspector General (IG) of the Office of the Chief of Naval Research, was concluded last month. While the IG did not examine Stanford's accounting practices, internal controls, or expense vouchers, he did find significant shortcomings in the ONR's administrative practices at Stanford. Among other things, he found that ONR

-- did not obtain a formal audit or legal review of any of the MOUs or special studies agreed to by ONR between 1980 and 1989;
-- did not properly review the special studies every 2 years as required by A-21; and
-- improperly excluded HHS from participating in past negotiations, rather than including it as required by OMB Circular A-88.

While the IG concluded that a ONR representative's much publicized estimate of $200 million in overcharges was judgmental and speculative in nature, he also stated that there appears to be some validity to the representative's concerns that the government has overpaid Stanford for indirect cost from 1980 to 1989. We believe the examples we have provided today lend further credence to the validity of those concerns. Fortunately, there is now a process in place to deal with them.

As you know, in December, the Chief of Naval Research, established a Special University Team, composed of senior ONR headquarters and field staff, to do a number of things. The team is to work closely with DCAA and representatives from other affected agencies to audit incurred costs for 1981 through 1989. More importantly, it will review all MOUs affecting the allocation of costs to the government. That process is continuing. DCAA is supporting that effort and, in response to a request from this

Subcommittee, is also intensifying its tests of individual transactions and vouchers.

In addition, Stanford itself has recognized shortcomings in its accounting system and in January announced a three-step approach to deal with these issues. The first step was to withdraw all G&A costs involving the Hoover House, Hanna House, and the Lake House, which I mentioned earlier. The second step was to hire a public accounting firm to independently assess Stanford's systems and procedures and to recommend appropriate improvements. The third step was to appoint a special advisory panel to review and advise on the implementation of improvements recommended in Stanford's accounting system and other matters related to accountability for federally sponsored research.

We believe the initiatives that are being taken, both by the government and Stanford, are positive and appropriate steps that must be taken to bring the problems identified under control. We would be pleased to work with these entities to assist in resolving the problems at Stanford. However, we believe we now need to look beyond Stanford to determine whether the problems identified at Stanford also exist at other universities and, if so, what can and should be done to protect the government's interest. Among other things, such a determination may call for changes to OMB Circular A-21 that might be need and an examination of the government's approach for reimbursing indirect costs at universities.

This concludes my statement, Mr. Chairman. I would be glad to answer any questions.

HOW INDIRECT COSTS ARE ACCUMULATED AND ALLOCATED TO FEDERALLY SPONSORED RESEARCH

Indirect costs--such as administrative expenses, utility and maintenance expenses, and depreciation--are costs that are not readily and specifically identifiable with a particular sponsored project, an instructional activity, or any other institutional activity. These indirect costs are distributed among various direct cost objectives, such as instruction and "organized" or sponsored research (which at Stanford is primarily federal research but also includes non-federal research), and other institutional activities which represent the major functions of the university.

At universities, such common costs are normally accumulated in seven indirect cost categories, or "pools," including

-- depreciation and use allowances,

-- operation and maintenance expenses,

-- general administration and general expenses,

-- departmental administration expenses,

-- sponsored projects administration expenses,

-- student services administration expenses, and

-- library expenses.

Some of the indirect cost pools are further broken down into several cost groups within that pool. Before indirect costs are assigned to a particular cost pool or cost group, however, they must first be reviewed to determine if some or all of the costs might be unallowable under A-21 criteria. Such costs are to be removed from the accounts so that only the allowable costs in each account are to be charged to each pool. The allowable costs are then assigned to the appropriate indirect cost pool for allocation to cost objectives, such as organized research, on the basis of formulas that are consistent with the benefits received or other equitable relationships. The basis for allocating each pool varies but is generally based on what are known as "modified total direct costs" (MTDC) for each cost objective to which costs are to be allocated.[2] For some pools, other bases are used, depending on what A-21 requires or what the university determines to be a fair basis for allocation. Thus a portion of each pool is allocated to each cost objective, as appropriate, including to organized research.

After all costs have been allocated to the relevant cost objectives, the total costs allocated to organized research are used to determine the indirect cost rate. The actual rate is roughly the total indirect costs allocated to organized research divided by the MTDC base for organized research. The total cost allocated to organized research times the federal participation rate in organized research, equals the total indirect costs to be paid for by the government for federally sponsored research.

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[2] MTDCs include salaries and wages, fringe benefits, materials and supplies, services, travel, and the amount of any subgrants and subcontracts up to $25,000 each. MTDC specifically excludes, among other things, purchased equipment and the amount of subgrants and subcontracts over $25,000 each.

EXAMPLES OF UNALLOWABLE COSTS CHARGED BY STANFORD TO FEDERAL RESEARCH

Our examination of selected accounts and transaction detail identified the following instances in which costs were erroneously charged to the government:

-- Athletic Equipment. Stanford erroneously charged $184,286 in depreciation costs to the government from 1981 to 1988 for numerous items of athletic department equipment, including outboard motors, racing sculls and, primarily, the 72-foot yacht, Victoria. Stanford officials initially assured us that none of the costs for their sailing program or the yacht were charged to the government. However, when we requested documentation for the actual yacht purchase, they discovered that depreciation costs for the yacht, as well as for the other equipment, had erroneously been included in the equipment depreciation pool charged to federal research. These charges had been occurring for at least 10 years, and while the costs did not become significant until the Victoria was purchased, certainly there was a breakdown in accounting and internal controls that allowed these charges to continue undetected for so long.

The Victoria was actually purchased in fiscal year 1988 under what Stanford officials call their "boat donation program."

Under this program, Stanford pays a price well below market and the seller "donates" the remaining value. The university paid only $100,000 for the Victoria, which was appraised at $1.2 million. Since the yacht was recorded at its appraised value, Stanford had already recorded depreciation of $120,000 the year it was purchased, of which the government paid about $50,000, despite the fact that it paid only $100,000 for the boat itself. The boat has been on the sales market for many months, currently at a price of $475,000.

-- Shopping Center Administration. The Stanford Shopping Center is an open air mall with several flagship department stores. It is owned and operated by the university, and thus Stanford pays for the administration of the center including administrative salaries and related expenses. These expenses were properly eliminated from the General and Administrative (G&A) cost pool in fiscal year 1985, but erroneously remained in the pool in fiscal years 1986 and 1987. Although the expenses were properly eliminated in fiscal year 1988, the university never corrected the 1986 and 1987 charges. As a result, a total of $707,737 in shopping center costs was added to the G&A pool for those years, of which the government paid $185,872. While such errors highlight a breakdown in accounting control, of greater concern is the failure on Stanford's part to correct those earlier years once the error was discovered. Stanford officials agree that these charges were erroneously left in the G&A pools in 1986 and 1987 and have agreed to make adjustment to the government. However, they were unable to explain why corrections were not made to those years once the error was discovered in 1988.

-- Public Relations. OMB Circular A-21 specifically disallows costs incurred for public relations activities, yet Stanford included $7,198 in the G&A pool for producing the Community Report, a semi-annual booklet that was sent to homes in nearby communities to promote university activities. The university also charged $2,164 in travel expenses for a member of Stanford's Public Affairs office who went to Paris for an alumni conference on "public relations, press coverage and news coverage." In addition to disallowing public relations costs, A-21 also disallows alumni activities and specifies that foreign travel costs for any purpose are allowable only when the travel has received specific prior approval, which Stanford did not request nor obtain from the cognizant agency. Although this example violated several A-21 provisions, the item remained in the G&A pool. For these two items, the government paid $2,449. Stanford officials agreed these items should have been eliminated from the G&A pool.

-- Advertising Costs. A-21 specifically states that the only advertising costs allowed are those necessary to meet the requirements of a sponsored agreement, such as recruiting personnel, procuring goods and services, and disposing of surplus materials. We determined that Stanford included $2,733 in the G&A pool for advertisements to promote student attendance at the summer session. The university also spent $2,274 for numerous advertisements on career week for students and career placement office services, and $905 to advertise positions for operating an investment fund, both of which were charged to the Student Services pool. Not only is such advertising prohibited, but A-21 also specifically disallows any costs of investment counsel and staff and similar expenses incurred for investments. For these items, the government paid $1,296. Stanford officials agreed that all three charges were improper.

-- Entertainment Costs. Stanford and ONR worked out an MOU in 1979 that allows Stanford to deduct a flat 20 percent of all subsistence costs in the G&A and Departmental Administration pools. The 20-percent deduction represents unallowable entertainment charges, which eliminates the need to track and eliminate specific charges. However, we identified several examples in which subsistence costs were not charged to subsistence accounts and thus were not reduced by 20 percent. For example, Stanford charged over $2,000 for alcoholic beverages for the Lake House (the university-owned residence of the Vice President of Public Affairs) which were not charged to subsistence, resulting in the total costs staying in the G&A pool. In addition, we found costs for an office picnic, a shower, and a party that likewise were not charged to subsistence and therefore, were included in full in the G&A pool. Had these been properly recorded, an additional $480 would have been eliminated from the G&A pool. Stanford officials disagreed that the costs for the picnic, shower, and party mentioned above were unallowable entertainment. Instead, they believed they were allowable employee morale, health and welfare costs under A-21. However, they agreed that all of the above items should have been charged to subsistence, and thus they should have deducted 20 percent.

-- Fundraising Activities. A-21 states that costs of organized fund raising, including financial campaigns, endowment drives, solicitation of gifts and bequests, and similar expenses incurred solely to raise capital or obtain contributions are unallowable. However, charges to the G&A pool included $2,012 for a donor recognition luncheon at the President's house, and $1,228 to the library pool for a staff member to travel to meetings with potential corporate donors. Stanford agreed these charges, for which the government paid $834, should have been eliminated.

In addition, we reviewed various fundraising transactions included in Office of Development accounts, including thousands of dollars in expenses incurred for various fund-raising dinners, travel costs for visiting prospective donors, and publication costs for various fund-raising booklets. While Stanford excluded various percentages from these accounts to represent unallowable costs, we found they did not have adequate documentation to support their calculations. For example, Stanford excluded 82 percent of the Office of Development's School Support account from the G&A pool as unallowable costs. However, the university has not been able to substantiate which specific costs were taken out and which costs were left in; thus, whether the 18 percent of costs, which totalled $328,354, that remained in the pool was allowable is unknown. In addition, another one of the Office of Development's accounts specified for elimination in full from the G&A pool was only 82 percent eliminated. The remaining 18 percent, equating to $10,900, erroneously remained in the pool. As a result, the government paid an additional $2,851 for this account.

-- Student Activities. While A-21 allows certain student services, such as admissions, registrar, counseling, and placement activities, to be charged to the student services cost pool, it specifically disallows intramural activities, student publications, student clubs, and other student activities. However, we discovered that Stanford charged to the pool the full costs of several student activity-related accounts, such as the Fraternity Task Force, totalling $68,324, of which the government paid $12,489.

We also reviewed several transactions in other student services accounts such as "freshman orientation." We identified costs of $589 for movie rentals, $875 for two bands for a student dance and a performance, $1,740 for soft drinks and rental of several sound systems, and $2,310 to rent vans for hauling student luggage. In other accounts, we also found such charges as $2,350 for airport shuttles, $900 for a chartered tour of San Francisco and a "beach trip," and $2,538 for furniture for student clubs. As a result of these charges, the government paid $2,072.

Stanford officials disagreed that the orientation accounts mentioned above are unallowable. They stated that their student orientation costs are part of a program to orient students to the campus and improve their retention. However, we believe the examples cited are not appropriate charges to the government.

-- Other Costs. In reviewing the Operations and Maintenance pool, we came across some costs that do not appear allocable and should have been disallowed from the pool. For example, we discovered that the O&M costs of the Chancellor's residence--a residence not owned by the university--are still being charged to the pool even though the Chancellor retired in 1968 and died in 1985. From 1986 to 1990, these costs amounted to $218,230, of which the government paid about $63,931. Because the residence no longer serves in an official capacity, does not benefit research, and is not necessary for the operation of the university, none of the costs should be allocated to research. Stanford officials stated they believe such costs are appropriate, since the agreement was entered into while the chancellor was alive and thus represents an employee benefit.

EXAMPLES CONCERNING STANFORD'S ALLOCATION OF COSTS TO FEDERAL RESEARCH

Additional allocation problems we found which resulted in higher allocations of costs to organized research than the default method, yet without adequate justification include:

-- Operation and Maintenance (O&M) Costs. Stanford conducts an annual space inventory to determine the functional use of each room in each building. It then categorizes all space on campus as either academic space or auxiliary space. Academic space is that used for academic functions such as instruction, research, libraries, etc. Auxiliary space is space used for nonacademic, or auxiliary, functions such as food and housing facilities, the bookstore, and the student union. Some O&M costs, such as general campus O&M costs, are allocated to academic space only. While Stanford, on the basis of an MOU accepted by ONR, excludes costs associated with auxiliary functions from the allocations and charges them directly to the auxiliaries, we found that they narrowly define costs associated with the auxiliaries and thus eliminate relatively few costs. For example, Stanford has numerous roads that run throughout the campus. In allocating the costs associated with maintaining these roads, only those costs relating to the relatively few roads that run directly in front of or to an auxiliary function, such as a dorm, are charged to the auxiliaries. The vast majority of roads that serve the entire campus are assigned only to the academic space, which thereby results in a higher allocation of costs to organized research. In 1986, $4 million in general campus O&M costs were allocated to organized research, of which the government paid $3.4 million.

-- Capital Improvement Depreciation. Stanford also uses the space inventory to allocate depreciation costs of capital improvements, such as outdoor lighting, parking lots, and general campus landscaping. In 1986, such charges to organized research totalled over $700,000. A-21 requires that such costs be allocated to user categories of students and employees on a full-time equivalent basis, with a further allocation based on the proportion of salaries and wages of employees in the various functions. Stanford, however, has an MOU, accepted by ONR, which allows it to allocate these costs to academic space on the basis of the space inventory without adequate justification. As a result, because a portion of these costs are allocated only to the academic functions, a higher share of them is being allocated to organized research, thus to the government.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our review was performed in response to a September 7, 1990, request from the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, to examine how universities charge and allocate indirect costs to federally sponsored research grants and contracts. At their request, we began our work at Stanford University. Our objectives included determining the types of costs that go into the indirect cost pools and examining Stanford's methods of allocating these cost pools to organized research to assess how the indirect cost rates are determined. In doing so, we also sought to determine whether adequate internal controls were in place to ensure that only appropriate costs are charged and allocated to the government. We also looked at the oversight provided by the Office of Naval Research (ONR), the cognizant agency responsible for negotiating the indirect cost rates with Stanford.

To accomplish our objectives, we met with Stanford officials to obtain an understanding of their accounting and allocation systems. We also met with ONR and Defense Contract Audit Agency (DCAA) officials to obtain their input on Stanford's procedures and to determine their roles in the audit and negotiation process. We met with Office of Management and Budget (OMB) officials to obtain additional background and perspective on the intent and substance of A-21 and other criteria. We also met with officials at the Department of Health and Human Services (HHS), which is the cognizant agency responsible for negotiating indirect cost rates at most of the colleges and universities in the country, and with officials from the Association of American Universities (AAU), which issued a 1988 report on its evaluation of the A-21 indirect cost system, to obtain additional background on the history of federally sponsored research at universities, and to obtain a perspective on the indirect cost processes at other universities.

As negotiations with Stanford are still open for fiscal years 1981 to the present, we focused our review on fiscal year 1986, the last year audited by DCAA, in order to take advantage of DCAA's experience and findings. Where problems in specific areas were found, we also reviewed those areas in the other years as well. We judgmentally selected for review 74 accounts from four of the indirect cost pools on the basis of the materiality of the accounts or because, based upon A-21 criteria, such accounts appeared warranted to review. From these accounts, we selected and reviewed 219 transactions in light of A-21 requirements, supplemented by discussions with Stanford officials on each item.

As the costs charged to the various direct cost objectives, including organized research, are influenced more by the methods of allocation than by individual transactions, we also reviewed Stanford's allocation methodologies for charging costs to organized research, placing particular emphasis on the depreciation and operations and maintenance (O&M) cost pools. As the allocations are heavily influenced by Stanford's 90 MOUs and special studies, we reviewed the current special studies and selected MOUs against A-21 requirements in conjunction with our review of the cost pools. We also reviewed Stanford's compliance with these MOUs and special studies.

We have also considered the results and implications of other inquiries at Stanford, including the recently released report by the Inspector General of the Office of the Chief of Naval Research. We met with the Chief of Naval Research and with the ONR special team to determine the status of their ongoing work at Stanford. We met with DCAA officials to determine the status and approach of their audits at Stanford as well as preliminary results. We also discussed with Stanford officials the status of the review initiated by Stanford which is being conducted by a public accounting firm.

Mr. Dingell. Mr. Socolar, the committee thanks you and Ms. Eng and Mr. Ols. Ms. Eng or Mr. Ols, do you have any comments you would like to make at this time to the committee?

Mr. Socolar. Not at this time.

Mr. Dingell. I beg your pardon?

Mr. Socolar. Not at this time.

Mr. Dingell. Very well. The Chair now recognizes my dear friend, the gentleman from Georgia, for questions under the rules.

Mr. Rowland. Thank you very much, Mr. Chairman. Mr. Socolar, the GAO was asked by the subcommittee to review a number of vouchers in various accounts at Stanford University. Based on that review we understand you found a number of expressly unallowable charges in a variety of accounts going to the Government. Is that correct?

Mr. Socolar. That's correct, sir.

Mr. Rowland. Could you cite some of the examples that you found?

Mr. Socolar. Yes. We did find costs that were associated with the shopping center that were specifically unallowable on the basis that the shopping center is an activity of the university that is totally unrelated in any way to research. We found examples of depreciation charged for athletic equipment that were related to auxiliary activities totally unrelated to research. We found items that were related to advertising for positions for the operation of an investment fund, items that were related to the floral supplies, wine supplies, and we found items that were related to student activities or recreational type activities that would be unallowable under the guidelines in A-21.

Mr. Rowland. I've been given a brochure here relative to the Stanford shopping center. Is that the one to which you——

Mr. Socolar. That's correct. Mr. Ols reminds me that Attachment 2 to the detailed statement that I have had introduced into the record contains a list of all of those unallowable costs.

Mr. Rowland. I see. There were public relations, lobbying, alumni activities, commencement, an array of different activities.

Mr. Socolar. That's correct.

Mr. Rowland. And that is included in the list that you——

Mr. Socolar. Yes, that is.

Mr. Rowland. In 1987 and 1988 Stanford certified to the Government that there were no expressly unallowable charges in their account under criminal penalty. It would appear that Stanford's certification to the Government regarding 1987 and 1988 may be false. Is that true?

Mr. Socolar. It may be inaccurate, yes, incorrect.

Mr. Rowland. Would you say false or incorrect?

Mr. Socolar. I would say incorrect. When you say false, that generates in my mind a question of what the intention was behind the certification and in the absence of an intention to be incorrect, I would hesitate to use the term false.

Mr. Rowland. Have you looked for intent?

Mr. Socolar. No, we have not.

Mr. Rowland. For months Stanford has been publicly stating that with the exception of the yacht the university has followed proper guidelines in billing the Government. Based on your audit, do you believe Stanford has in fact followed proper guidelines regarding billed transactions to the Government?

Mr. Socolar. I think that there are items billed to the Government that do not conform with the guidelines. I think that some of the responsibility surely must fall on ONR because Stanford did present studies, did present items for specific memorandums of understanding which were accepted without question, without review, and had those been adequately reviewed and questioned, as I said in my summary statement, we might not be here today.

Mr. Rowland. Well, let me ask you something about the $10,000 in silver.

Mr. Socolar. Yes, sir.

Mr. Rowland. Could you explain how Stanford attempted to circumvent regulations concerning this charge?

Mr. Socolar. Well, the silverware has a particular history. They were donated to the university in 1979 with the stipulation that any proceeds from their sale be used for library purposes.

The silverware itself was appraised in 1984 and as I indicated was appraised on the basis not as a total donation but as separate items, each coming under the $500 limitation for capitalization and then not charged to the Government until 1986.

Mr. Rowland. Well, the silver was broken down into knives, forks, spoons—why do you think this was done?

Mr. Socolar. That was the basis on which the appraisal was calculated and totalled up and then because the appraisal—this is an assumption on my part—because the appraisal was put together that way it was determined that it would be all right to charge the Government on that basis.

Mr. Rowland. Well, could they have billed the lump sum of $10,000?

Mr. Socolar. No. That would have had to have been depreciated and only a portion of the depreciation charged to the Government and that is, even if one accepts the appropriateness of charging the Government at all for a donated set of silver.

Mr. Rowland. So to put it in the Government account it had to be broken down into $500 or less increments?

Mr. Socolar. I'm sorry, I didn't hear you.

Mr. Rowland. To put it in the Government account, it had to be broken down into $500 or less increments?

Mr. Socolar. To be charged all in the 1 year, yes.

Mr. Rowland. To be charged in 1 year.

Well, someone intentionally manipulated the charge so Stanford could bill it apparently, is that true?

Mr. Socolar. You're asking me for a statement of intent again and I hesitate to attribute any specific intent to any of these charges.

Mr. Rowland. Well, if that was the case, that would be fraud, if that was done, is that not correct?

Mr. Socolar. Conceivably, yes.

Mr. Rowland. Mr. Chairman, I see——

Mr. Dingell. Would the gentleman yield?

The Chair announced that the Chair is going to recognize the members for 10 minutes rather than 5 so the gentleman can disregard the red lights down there. The Chair has got a very fine stopwatch here that is helping the Chair keep an eye on the time.

Gentlemen, if the charges were intentionally manipulated, is that not fraud?

Mr. Socolar. I would respond yes to that.

Mr. Dingell. Can you exclude the fact that these charges were intentionally manipulated?

Mr. Socolar. Intent—well, I would have to add intentionally manipulated for the purpose of charging the Government that which was known to be inappropriately chargeable.

Now it is clear that in the case of the silverware the items were dealt with on an individual basis. Whether that was done expressly for the purpose of defrauding the Government is something I would rather not respond to.

Mr. Dingell. Is it necessary to have the specific intent to defraud the Government or is it simply necessary to commit fraud to seek to achieve something which is not proper for the university to receive?

In other words, does—we are getting now into a legal question of intent. Does "intent" in this instance involve the intent to do wrong? Or the intent to simply receive funds that are not properly coming to the university?

Mr. Socolar. I would suggest intent to do wrong.

Mr. Dingell. I think that is rather unusual. Doesn't manipulation indicate though that the person intended to do that which he did?

Mr. Socolar. It could.

Mr. Dingell. And doesn't it indicate that he knew full well what he was doing?

Mr. Socolar. Yes, it does.

Mr. Dingell. Aren't we agreed that in these instances the term properly applied here is "manipulate"?

Mr. Socolar. I could go along with that.

Mr. Dingell. How then do you exclude fraud, if you intended then to assert charges which were not proper?

Mr. Socolar. I think it is important to have an understanding of the relationship between the university and the Government in terms of how the university dealt with the Government in these kinds of situations.

I am being hesitant here because I just simply am uncomfortable in making a public charge of fraud without having looked into the situation specifically enough.

Mr. Dingell. But you are not, however, excluding the possibility that there may have been fraud in this instance?

Mr. Socolar. That is correct.

Mr. Dingell. Very well. Thank you.

There is a vote for the approval of the Journal. The Chair will announce that the committee will recess at this time. We will return as quickly as the vote is over and the Chair will recognize the gentleman from Georgia for 2 additional minutes on his return. We will recognize all members for 10 minutes this morning because of the complexity of the questions before the subcommittee. The subcommittee will stand in adjournment then for approximately 15 minutes while we go vote.

[Brief recess.]

Mr. **Dingell**. The subcommittee will come to order. The Chair recognizes again the gentleman from Georgia.

Mr. **Rowland**. Thank you, Mr. Chairman. When we left off a few minutes ago, we were exploring the possibility as to whether or not there may have been some fraud. Let me ask you this; do you think that this may be a cat-and-mouse game, catch-us-if-you-can attitude at Stanford?

Mr. **Socolar**. It seems to me that Stanford was taking advantage of every possible claim that it could to even remotely justify in its own mind.

Mr. **Rowland**. Let me go to something else here. Can you tell us what happened when GAO attempted to ask Stanford about the 90-foot yacht that they were billing the taxpayers for?

Mr. **Socolar**. Mr. Ols dealt directly with that issue, and I think it might be just as well for him to respond.

Mr. **Ols**. Yes, when we visited Stanford we started our job last October. Because that had been noted in the newspapers and had been questioned, I specifically put that question to the Controller and the Assistant Controller as to which account did the yacht appear in? In other words, where were the costs? Who was accounting for it?

I was specifically told that, in fact, there was no such yacht—and it was a 72-foot yacht.

Mr. **Rowland**. There was no yacht at all?

Mr. **Ols**. That's right; that none of the accounts contained the cost in any regard as it related to the yacht.

Mr. **Rowland**. Maybe you're going to tell me this, but when did they finally acknowledge the yacht?

Mr. **Ols**. Our staff and Doreen Eng who is with us here at the table, continued to pursue that particular question, looking at various accounts and vouchers and actually kept pushing to get them to uncover and realize that, in fact, that the yacht was included in their accounting system and that depreciation charges were being passed on to the Government.

Mr. **Rowland**. Now, once then that they did admit the existence of a yacht and then did admit that there were some of those charges relative to that that we were paying for——

Mr. **Ols**. That's right; they actually went on the public record and, I believe, sent a letter to the chairman, acknowledging that and, in fact, saying that the costs would be withdrawn out of the overhead account.

Mr. **Rowland**. Do you have any thoughts as to why it was first denied and later admitted?

Mr. **Ols**. To me, that's very difficult to explain; why one did not know that it was in the accounting system.

Mr. **Rowland**. It wasn't because someone was asked that initially didn't know there was a yacht, do you suppose?

Mr. **Ols**. I'm just not sure what was going through their mind and what their intent was as far as whether they knew, didn't know, weren't aware that it was in there, were not sure that, in fact, it was in accounting system and maybe just didn't realize it. I'm just not sure where they were coming from on that.

Mr. Rowland. I see my time has expired. Thank you, Mr. Chairman.

Mr. Dingell. The time of the gentleman has expired. The Chair recognizes now the distinguished gentleman from New York, Mr. Lent.

Mr. Lent. Thank you, Mr. Chairman. Mr. Socolar, will you explain the difference between allowable, reasonable and allocable? In other words, if an expense is not allowable, should we even get into the question of whether the expense is reasonable or whether the expense is allocable?

Mr. Socolar. An unallowable expense is one that is specifically so designated in A-21. An unallocable expense is one that is not allocable to research purposes.

What was the third category that you mentioned?

Mr. Lent. Reasonable.

Mr. Socolar. Reasonable gets to the question of appropriateness. Is it appropriate to be charging the Government for flowers, for wedding receptions and the like?

Mr. Lent. My point is, do we need to get to the question of allocability unless we first pass the tests of allowability?

Mr. Socolar. No. If it's unallowable, you don't go any further.

Mr. Lent. For example, athletic equipment which is referred to in Attachment 2 of your testimony, which gives examples of items which Stanford erroneously charged to the Government, athletic equipment is an issue of allowability as opposed to reasonableness or allocability; is that correct?

Mr. Socolar. Yes. It is an issue of allowability.

Mr. Lent. Well, if it's not allowable, why do we need to reach allocable?

Mr. Socolar. Those expenses are not, by their terms, made unallowable under A-21. The reason for questioning those relates to whether there's any reasonable basis to allocate those kinds of expenses as expenses of the university for which research should bear a proportionate share.

Mr. Lent. Let me give you another example. The Stanford Shopping Center; should we even be discussing reasonableness and allocability here or is the charge clearly unallowable?

Mr. Socolar. It's clearly unallocable. There are a limited number of expensed items under A-21 that are unallowable, items that relate to the investments of the university, items that relate to certain kinds of advertising.

The other aspects of the university operation that are not specifically designated as unallowable, one needs to determine whether research in any reasonable formulation should pick up a portion of the costs.

Mr. Lent. Let me give you a third example now, public relations. Public relations costs are specifically unallowable by OMB Circular A-21?

Mr. Socolar. That's correct. So there's no question with respect to public relations, no question of reasonableness or allocability?

Mr. Socolar. That is correct.

Mr. Lent. OK, now let's look at the subsistence costs in the General and Administrative and Departmental Administration Pools. If Stanford is deducting 20 percent of all subsistence costs in these pools, as I believe they are, does that mean that the Government is picking up 80 percent of the costs in those pools?

Mr. **Socolar**. I'm sorry, I was diverted for just a second and I would appreciate it if you would repeat that.

Mr. **Lent**. Referring to page 21 of your testimony——

Mr. **Dingell**. Would the gentleman yield?

Mr. **Lent**. I'd be happy to yield.

Mr. **Dingell**. Returning to the Shopping Center, is that an approvable or allowable cost; or not?

Mr. **Socolar**. That is not an allowable cost. The Shopping Center is not allowable, it doesn't really relate to a University activity that would be allocable anyplace.

Mr. **Dingell**. It also makes money; does it not?

Mr. **Socolar**. Oh, yes.

Mr. **Dingell**. Lots of money?

Mr. **Socolar**. Yes.

Mr. **Dingell**. So, it made money, lots of money and the taxpayers were still allocated a part of the cost of that; is that right?

Mr. **Socolar**. That's correct.

Mr. **Dingell**. That's curious. Can you give me an explanation of why that occurred?

Mr. **Socolar**. The only reason that I can attribute it to is that the university simply picked up its depreciation costs and failed to eliminate the Shopping Center from its charges.

Mr. **Dingell**. It was administrative cost; was it not, Mr. Socolar?

Mr. **Socolar**. Yes.

Mr. **Dingell**. I thank the gentleman and apologize for intruding on his time.

Mr. **Lent**. Returning to that question that had to do with your statement at page 21 under Entertainment Costs, you indicate that Stanford and ONR worked out an MOU that allowed Stanford to deduct a flat 20 percent of all subsistence costs in the G&A and Departmental Administration Pools.

My question is; if Stanford is deducting 20 percent of all subsistence costs in those pools, does that mean that the Government is picking up 80 percent of the cost in those pools? Is there any further test for reasonableness of the charges to those pools?

Mr. **Socolar**. No, the Government is not picking up 80 percent.

Mr. **Lent**. Is there any provision for the allocation of the costs in those pools to reflect the indirect costs of research performed by Stanford for the Government?

Mr. **Socolar**. I'm not sure I understand the question.

Mr. **Lent**. Are there any other cuts in addition to the 20 percent before the Government is sent the bill?

Mr. **Socolar**. Yes. The costs for which only a portion is picked up by the Government. Again, we are back to the term "allocation." Only that portion which is allocated to research is then picked up by the Government.

Mr. **Lent**. How do you make that determination what pertains to research and what does not pertain to research?

Mr. **Socolar**. I think those are judgmental determinations that are made on the basis of all of the university activities and under various kinds of formulas are distributed out to the various university activities, of which research is one.

Mr. LENT. Is it fair to say, Mr. Socolar, that Stanford has been aggressive in allocating even allowable expenses to the Government. For example, you cite how Stanford allocates the cost of maintaining the campus roads.

The Government paid, as I understand it, almost ⅞ths of the cost of maintaining all of the campus roads at Stanford. What possible justification could there be for the Federal taxpayers picking up the tab for ⅞ths of the cost of Stanford's campus roads? The subsidiary question is whether this is another example of where an MOU between Stanford and ONR has worked to the substantial disadvantage of the Federal Government?

Mr. SOCOLAR. Well, in answer to the first part of your question, I would say yes, Stanford has been very aggressive and, in the way that Stanford billed the Government for its road maintenance, that becomes evident. Because what Stanford did was with regard to a segment of its activities, it pulled out from road costs a very minor portion associated with an activity that was not chargeable and then charged the remainder to all of its academic activities, rather than to have included a part of that to the unallowable item. In other words, what Stanford did was maximize the amount of charge that would go to the Government.

Mr. LENT. Yes. So you would agree with the suggestion in my question that Stanford has been aggressive?

Mr. SOCOLAR. Yes.

Mr. LENT. Is this an example of where an MOU between Stanford and ONR has worked to the substantial disadvantage of the Government?

Mr. SOCOLAR. Yes.

Mr. LENT. There was an MOU?

Mr. SOCOLAR. Yes, there was.

Mr. LENT. OK. I see the red light is on. I understand my time is up. I didn't want to cut it off. Thank you, Mr. Chairman.

Mr. DINGELL. The time of the gentleman has expired. The gentleman from Texas, Mr. Bryant?

Mr. BRYANT. Thank you, Mr. Chairman.

Mr. Socolar, a moment ago, our colleague was asking questions about the yacht. I would like to ask you when you made your first inquiry about the yacht? Feel free to refer this question to one of your associates, if necessary. Who exactly did you ask about the yacht? Who exactly denied that the yacht existed?

Mr. OLS. As I indicated, in response to the earlier question, the Controller, who was Frank Riddle and the Assistant Controller, Janet Sweet, were in the meeting at Stanford University, when I posed that question to them.

Mr. BRYANT. They told you that the university did not own——

Mr. OLS. Did not own, did not have such a yacht neither in their control nor in their accounting system.

Mr. BRYANT. Now, didn't evidence, or rather photographs or references to that yacht, exist in their Sailing Club brochure?

Mr. OLS. Not to my knowledge. I have not seen that. Doren, who has been doing work at Stanford might have.

Ms. ENG. Yes, that's true. It was highlighted in their Stanford Sailing Program brochures.

Mr. Bryant. All right. So their own brochures indicated they had a yacht, yet the Controller of the university was denying that they had a yacht when a Government investigator was asking about it?

Ms. Eng. Initially, that's true.

Mr. Bryant. It seems to me impossible that they would have not have known it. Am I assuming too much? Is it possible? I mean, did you have the feeling that it was just simply a mistake, that they didn't know they owned a yacht?

Ms. Eng. Based on our initial questioning, we did not have any specific evidence either, only allegations. So, we did not know and could not tell, from their responses, whether or not the yacht existed.

Mr. Bryant. Now the yacht, I assume, since it turns out that it was indeed owned by the university, or is indeed owned by the university, would have certain expenses associated with it, year-in and year-out. Those expenses and the paying for them would certainly come to the attention of the controller and the assistant controller, wouldn't they, year-in and year-out?

Ms. Eng. That is correct. Initially, when we were told that there wasn't a yacht, they came back later and said that there was a yacht, but none of the expenses of the yacht were charged to the Government. They did provide us those expenditure details, and we did review the costs of the sailing program and the cost of maintaining, such as the insurance and so forth, and none of those were charged to the Government.

It was only after I looked through those details and realized that the actual cost of the yacht, that is, for the yacht itself, were not included in those details. It was only after I asked for documentation of the actual purchase of the yacht that, about a month or so later, they came back and said that, unfortunately, the depreciation had been charged to the pools and therefore, to the Government.

Mr. Bryant. So, first the Controller of Stanford University said "We do not own a yacht"?

Ms. Eng. That is right.

Mr. Bryant. Then he came back and said, "Well we own one, but do not worry, we are not charging the Government for maintaining it or for any expenses associated with it"; is that right?

Ms. Eng. That is correct.

Mr. Bryant. Then he came back and said "Well, we made a mistake, indeed, we are"—after you asked for the records, he came back and said, "Well, indeed we are in fact charging the American taxpayer to pay for a yacht at Stanford University"; is that correct?

Ms. Eng. That is correct.

Mr. Bryant. Mr. Socolar, your staff has told the subcommittee staff that Stanford has admitted to a number of other erroneously charged account items, such as the Shopping Center, a trip to Paris, alumni functions, public relations functions and so forth. Even though Stanford has admitted to these problems, I think the question should be asked today, have they repaid the Government for these charges which they have admitted were not properly made?

Mr. **Socolar.** I am not sure that they have. I am not sure that the issues have been fully resolved.

Mr. **Bryant.** The subcommittee staff's understanding is that they have not taken out anything except the yacht and the three houses; is that consistent with your information?

Mr. **Socolar.** Yes.

Mr. **Bryant.** Would it be appropriate to ask you for a response to a simple question? Do you believe the accounting system and internal controls at Stanford are adequate, based upon the investigation done by your Agency?

Mr. **Socolar.** I think certainly, with regard to the kind of control—internal control, in connection with these items, that there is a lot to be desired. I have not looked at the accounting system, per se, to make a judgment on that.

Mr. **Bryant.** OK. What is your understanding as to why an institution like Stanford, which claims to have—and probably does have—one of the best business schools in the world, is unable to set up and implement its own accounting system with proper internal controls?

Mr. **Socolar.** I think it relates back to the question that I addressed before as to whether Stanford was pursuing an aggressive policy here. I think, as I said before, the answer to that is yes, and Stanford was taking advantage of every opening that presented itself, and unfortunately, the Navy was not looking at those openings to see where they would lead.

Mr. **Bryant.** OK. So, you have given us a motive for what they were doing, and apparently, I would imply from your answer, that they did not want to have the kind of internal controls which would be necessary to prevent this bilking of the taxpayer; is that a fair conclusion?

Mr. **Socolar.** Yes, stated that way. I think it could be stated another way too, though. That is that they had enough control to know what it was they were billing the Government for.

Mr. **Bryant.** So, they did know what they were doing?

Mr. **Socolar.** It would seem so, yes.

Mr. **Bryant.** OK. Well, going back to the chairman's earlier inquiry; why isn't that fraud?

Mr. **Socolar.** The question there gets back to whether there was an understanding of what was unallowable, what was unallocable and what the Government, itself, was aware of as these billings came forward. In other words, the Government did sign on to these MOU's, it did sign on to these special studies that Stanford was implementing.

I think that the basic question and the basic issue along those lines, really gets to the question of how those MOU's were being implemented; how those special study charges are being implemented?

Mr. **Bryant.** Well, my colleague from Minnesota suggested that it would be fair to inquire if the Government did sign on the thing for a yacht or for a shopping center?

Mr. **Socolar.** No, it did not.

Mr. **Bryant.** Well, so, in effect, that money was charged to the taxpayer without the taxpayers' Government understanding what was happening; isn't that correct?

Mr. **Socolar**. Yes, but I am not sure, and I cannot say, from the work that we have done, how the yacht charges got into the account.

Mr. **Sikorski**. Would the gentleman yield?

Mr. **Bryant**. I yield.

Mr. **Sikorski**. When the yacht was asked about, an untruth was told.

Mr. **Socolar**. Yes, but I do not know whether it was an intentional untruth or an untruth out of ignorance.

Mr. **Sikorski**. Well, you seem to be, and I am not critical, because I think if I were sitting in your seat, too, but it is important to understand. You seem to be stretching for a criminal definition of intent. There is civil fraud as well. The standard for both, as I recall, years back is did know or had reason to know. That a controller should be aware of the yacht showing up, not only in the accounting but in public relations.

It seems to me that this all goes to this issue where you don't want to tread as to intent and deceit and the rest of it. I just state that because the euphemism being employed here is an aggressive policy for what would be, in real life by real people, down and out people, would be a scheme to defraud or to flimflam or a scam or something of that nature; but here we are talking about aggressive reimbursement policies. It bothers me that this euphemism gets to cover these things.

Mr. **Socolar**. I do not disagree with what you say.

Mr. **Sikorski**. I thank the gentleman for yielding.

Mr. **Dingell**. Would the gentleman yield?

Mr. **Bryant**. I yield to the chairman, yes.

Mr. **Dingell**. What you have got here is a situation where we are compelled to perhaps make a choice between the thesis that Stanford was served by incompetent auditors or that Stanford was served by auditors who were less than honest in their presentation.

Now, if they were incompetent, clearly, there would have been mistakes which you had found which would have favored Stanford and which would have hurt Stanford. Is that a fair assumption?

Mr. **Socolar**. Yes.

Mr. **Dingell**. If they were, however, very confident, but not quite honest, we would find that none of the mistakes favored the Government, but all favored Stanford. Now is that a fair thesis or not?

Mr. **Socolar**. I do not disagree with the import of the questioning, at this point; but, as I said before, to make the kind of charge, as far as I am concerned, would require me to look into the situations more than I have. I simply am just not in the position to use the word "fraud" at this time.

Mr. **Dingell**. Did you find any instances whatsoever, in the course of the audit, where the errors favored the Government against Stanford?

Mr. **Socolar**. I do not know. Did we?

Ms. **Eng**. There was one instance.

Mr. **Dingell**. What? I'm comforted. What was that?

Ms. **Eng**. This was in the allocation of part of their utility costs, their steam costs.

Mr. **Dingell**. Yes.

Ms. Eng. And what they did was they allocated it to all buildings, regardless of who received steam or not.

Mr. Dingell. That was the only one that you found?

Ms. Eng. Yes.

Mr. Dingell. Very well. I thank the gentleman for his time.

Mr. Bryant. Mr. Socolar, turning to the Memoranda of Understanding, Stanford had negotiated as many as 125 MOU's with the Government during the 1980's. Now, that's correct, is it not?

Mr. Socolar. That's correct.

Mr. Bryant. And an MOU is an understanding under which they're able to charge more than they would usually be able to charge. Isn't that correct?

Mr. Socolar. That is correct.

Mr. Bryant. Now, those are usually backed up by a study or by written justification performed by the university in pursuing the granting of the MOU. Isn't that correct?

Mr. Socolar. That is correct.

Mr. Bryant. Now, I think it's clear from your testimony that you believe that many of these MOU's—I don't know if it's all, or most of them, or how many—but apparently they were not sound. They are not based upon any kind of a sound justification. Is that correct?

Mr. Socolar. We have found the ones that we have looked at to be unsupported and unjustified and accepted by the Navy without question, without review, either in terms of concept or from a legal standpoint. I am not able to express an opinion with regard to a majority or most of the MOU's because we haven't looked at them.

Mr. Bryant. With regard to all of the ones you have looked at, however, apparently, they are not sufficient to justify the public expenditure of funds to the extent they allow.

Leaving the Navy aside and the Government aside for a moment and just talking about Stanford University, who prepared the justification for these MOU's?

Ms. Eng. Stanford did.

Mr. Bryant. I mean, what person—if it's more than one person—what kind of person, what kind of an officer, at the university prepared them?

Ms. Eng. I can't say specifically, but the assumption is that at least the bulk of them would have been prepared by the controller's office and representatives of that office.

Mr. Bryant. All right. And give us an example of the extent to which they failed to justify a change, or did they consist of obvious misrepresentation—concealing of facts—which would have argued against granting the MOU? What kind of problems?

Ms. Eng. We haven't found any evidence of concealing of facts. Generally, it tended to be in the lack of justification, many of which are detailed in our detail statement.

I'll give you one example which we talked about, which was the use of the straight-line depreciation method, which A-21 proscribes—it states that the straight-line method will be used in the absence of clear evidence that either the buildings or the improvements or equipment deteriorates greater in the earlier years than the later years. The MOU merely states that it essentially reflects the economic depreciation of the asset, but it hasn't provided actual evidence of that.

Mr. **Bryant**. Did they also use invalid statistical methods?

Ms. **Eng**. No statistical methods are mentioned or reflected for that MOU.

Mr. **Bryant**. I'm talking about in general with regard to the MOU's that you looked at, not just that one.

Ms. **Eng**. Oh, I'm sorry. OK. Can you repeat the question?

Mr. **Bryant**. Did you also find the university's controller's office using invalid statistical methods?

Ms. **Eng**. In our opinion, some of the so-called statistical methods were not valid. We give an example of the utilities studies, where they said that the—one of the requirements for a special study is that it must be statistically sound, which is open to interpretation; however, in the utilities study, they base and project the results on the sample of 10 out of 660 building numbers.

Mr. **Bryant**. Ten out of 660?

Ms. **Eng**. Correct.

Mr. **Bryant**. My time is up. I would observe, however, Mr. Chairman, that Stanford University, I understand, has a widely renowned statistics department which may have assisted them, had they asked them to.

Mr. **Dingell**. The time of the gentleman has expired.

The Chair recognizes the distinguished gentleman from Michigan, Mr. Upton.

Mr. **Upton**. Thank you, Mr. Chairman.

Mr. Socolar, I am very concerned about the reports that have come out, both through the press and, I think, some of the questioning this morning, with regards to untruths or stonewalling, whether it be to you all, or whether it be the ONR. I'm curious to know when your investigation actually began?

Mr. **Socolar**. We began in October, 1990.

Mr. **Upton**. Are there other cases of evidence beyond what was described with the yacht, which I find appalling that they didn't know about from the first place, where you found them specifically not cooperative or less than enthusiastic about coming up with information that would provide you with some information?

Mr. **Upton**. During the course of our review, my understanding is, and I could have my colleagues comment after me, that we were not denied, except for one document, anything in the way of documentation for the issues that we were pursuing.

There was a tendency to take perhaps more time than might have been reasonable to finally respond, but the one document that we were denied was the management report to the university prepared by the university's accounting firm.

Mr. **Upton**. Have you since seen that document?

Mr. **Socolar**. No, we have not seen that document.

Mr. **Upton**. Find out in a while. OK.

What type of justification did they have in not giving you that document to date, and how long has that request been outstanding?

Ms. **Eng**. This just was denied last month, and we did not have time to pursue it.

Mr. **Upton**. Early last month? Late last month?

Ms. **Eng**. Probably early last month.

Mr. Upton. So it's been about 6 weeks?

Ms. Eng. I can't say specifically.

Mr. Upton. Did they have a reason as to why they would not furnish it?

Ms. Eng. Yes. They said that the management letter was an internal document.

Mr. Upton. OK. I noted in your testimony, on page 13, that you found a number of things with regard to ONR that they did not formally obtain an audit or legal review of any of the MOU's or special studies agreed to by ONR between 1980 and 1989, and that ONR did not properly review the special studies every 2 years as required by Circular A-21, and that they improperly excluded HHS from participating in past negotiations rather than including it as required by OMB Circular A-88.

What type of response did they have when you brought that to the attention of the ONR?

Mr. Socolar. Actually, those are the findings in the IG report, the ONR IG report, so that we didn't specifically address them.

Mr. Upton. So they recognized those responses, or they recognized those shortcomings?

Mr. Socolar. That's correct, yes.

Mr. Upton. OK. We've seen a laundry list, and we've heard a number of things that were improperly itemized in the report, and in addition to the Voltaire chairs and the tablecloths and linens and yacht, we had also heard a little bit about public relations costs earlier, which specifically should be excluded.

What evidence have you found or did you glean from Stanford as to what actually goes into their cost pool, or would that be in a missing document that has not been furnished?

Ms. Eng. I'm sorry, can you repeat that, please?

Mr. Upton. We have a list of a number of things that have been cited today, in the testimony today, including the linens, the yacht, the $750 to rework the bed, the chairs, the football lunch, et cetera. We've also heard in earlier testimony about public relations costs, which you have indicated in earlier questions should be specifically excluded from the MOU's.

Ms. Eng. Right.

Mr. Upton. What evidence have you found, if any, that would actually—what evidence have you gleaned from Stanford as to what actually should be included in the criteria of what should be an allowable cost and one that is not allowable other than perhaps the missing document that you've been unable to obtain?

Ms. Eng. In terms of what is allowable, those are the criteria we talked about earlier in A-21, which specify certain costs as specifically unallowable or allowable, as well as the reasonableness and allocability issues.

In the case of the public relations, we found two transactions which we questioned because they seem to fall under the category of public relations, which is specifically identified in A-21 as unallowable, and that was why brought those issues up.

We talked these over with Stanford officials. There was one which they stated they would look into further because they weren't sure that they agreed with that, but we never heard a response back on that one.

Mr. UPTON. OK. Thank you.

Mr. DINGELL. The time of the gentleman has expired.

The gentleman from Oregon, Mr. Wyden, and then the Chair will recognize next the gentleman from Minnesota.

Mr. WYDEN. Thank you. Thank you, Mr. Chairman.

On this point of the MOU's, let me see if you had touched on this, Mr. Socolar. Perhaps I had missed it.

Stanford has negotiated more than 125 MOU's with the Government during the 1980's?

Mr. SOCOLAR. That is correct.

Mr. WYDEN. In turn, the Government should have done a formal audit and legal analysis of these MOU's prior to agreeing to them. Shouldn't that have been done?

Mr. SOCOLAR. A review and legal analysis, yes.

Mr. WYDEN. Were those audits or legal reviews done?

Mr. SOCOLAR. No, they were not.

Mr. WYDEN. So, is it fair to say that the Office of Naval Research violated its own directives by entering into these Memorandums of Understanding without performing the necessary work?

Mr. SOCOLAR. That is correct.

Mr. WYDEN. Now, the Defense Contract Audit Agency has estimated that these Memoranda are costing the taxpayers almost $20 million a year.

Does the General Accounting Office believe that these Memorandums of Understanding are creating a situation whereby the university is receiving significantly more money that otherwise would be the case if the normal cost-accounting practices were followed?

Mr. SOCOLAR. Yes, they exceeded A-21 criteria.

Mr. WYDEN. They are receiving significantly more money.

Mr. SOCOLAR. The MOU's provide for greater reimbursement than the basic A-21 provides for.

Mr. WYDEN. Right.

Does GAO disagree with the estimate of the Defense Contracting Agency, DCAA, that the figure could be as high as $20 million?

Mr. SOCOLAR. We simply do not have an estimate of the overall amount. We have not done sufficient work to arrive at that kind of a number, and all I can say is that it is conceivable and possible.

Mr. WYDEN. Let us see which ones you may have some corroboration on. Let me ask you about a couple of the items specifically.

On the depreciation, do you all have some numbers on that point? My understanding is that that may be $4½ million, $4.6 million. Is that correct?

Ms. ENG. That was to the indirect cost pool as a whole. The Government portion was about half of that.

Mr. WYDEN. On the liability issue—excuse me—on the library issue?

Ms. ENG. Yes. If you look at our detailed statement, with respect to the library, we did not calculate that difference. That is Stanford's calculations which they had to prepare in response to DCAA. Their estimate for 1988 was a difference of about $7 million.

Mr. WYDEN. On the utility issue, what figures have you pulled together on that?

Ms. ENG. Again, these are Stanford's figures, and the difference was about $4 million.

Mr. Wyden. So, we are talking, according to what we have put together, something like $11 million. How much would the taxpayer pay for there?

Ms. Eng. These, if I remember correctly, are the Government portions. Let me look. Yes, they are.

Mr. Wyden. So, between these three expenditures alone—the depreciation issue, the library issue, and the utility issue—according to your calculations, we would be talking about perhaps a little bit over $13 million. Is that correct?

Ms. Eng. For that year.

Mr. Wyden. OK.

Mr. Socolar, the situation here, then appears that the Government has signed 125 Memorandums of Understanding without the proper audit and legal analysis, in violation of the Government rules.

In addition, the audit Agency of the Government is telling us that it may be costing upwards of $20 million, and on the basis of the computations we just went through with GAO, your figures would be upwards of $13 million, and that would be just for three areas—the depreciation, the library, and utilities. Do you believe that the Memorandums of Understanding, at this point, should be terminated?

Mr. Socolar. First, I think it is important to recognize that about 13 of those Memorandums cover about 80 percent of the costs. As to termination of the MOU's, I think the issue is really how best to deal with the situation that exists.

I certainly could subscribe to a termination of the MOU's. On the other hand, without having looked at that particular possibility, I do not know whether that is the best way to work out of the situation.

It might well be that a large number of them, there would not be any real question about, and we would only be having to redo them, but in answer to your question generally, I think that is certainly an option that should be very, very seriously considered.

Mr. Wyden. Are there legal problems associated with termination?

My concern here—and it almost seems obvious—is you get into a situation where the taxpayer, in effect, is blindly led into signing these kinds of agreements, and they could be costing tens of millions of dollars, and then to get out of these kinds of agreements, you are running up into another problem with respect to significant legal liabilities.

Is that a fair assessment of where we are left on this?

Mr. Socolar. Well, there, too, I think we have to keep in mind that we are not dealing with the payment to the university of expenses that it is incurring specifically to meet the requirements of the Government.

We are simply saying that with regard to expenditures that the university is making anyway, whether the research that the Government is ordering or not, those are items that would be expended by the university, and so, I do not think that there would be a great problem in terminating these MOU's, at least from the prospective standpoint.

Mr. Wyden. To go back, there would be a problem.

Mr. **Socolar**. To go back, I think, would—first of all, I think is essentially a problem that would require some kind of, perhaps, even negotiation over what has occurred in the past.

As to legitimate claims that might be made for what has occurred in the past, I think there we would have to get into questions as to whether the university was deliberately noncompliant with the Memorandums and the special studies.

Mr. **Wyden**. I want to move on, and I think you have touched on it well, and I think you understanding my concern is that, you know, if you are first led into signing these agreements which do not protect the taxpayer and then you have problems getting out of them, it is sort of like they have got us coming and going, and that is obviously the worst of all worlds.

Now, you do a number of audits of various Government contractors, and I am interested in whether you can cite another contractor whose accounting system and internal controls allow the kind of charging that has been seen in the case in point.

Mr. **Socolar**. Well, I think that with regard to Federal contracting, generally, that this is somewhat of an endemic problem, that we quite often go into contracts and find poor internal controls and charging against the Government items that should not be charged.

Mr. **Wyden**. Are there any specific contracts that you could cite where you saw this kind of problem? In fact, let me restate it—any specific contractors where you have seen this kind of problem?

Mr. **Socolar**. Well, the chairman referred in his opening statement to General Dynamics, which we had reviewed some years ago.

Mr. **Wyden**. Are you comparing this to General Dynamics?

Mr. **Socolar**. In terms of some of the kinds of things that are being charged, yes.

Mr. **Wyden**. Now, this situation has gone on for quite some time, and yet, you all, with several auditors, began to unravel the situation in a matter of months.

Do you think there is any logical reason why it should have taken Stanford and the Navy so long to get at this when you all began to unravel it in just a couple of months?

Mr. **Socolar**. I think it was, for a long time, a situation that was totally unattended, that there really was not the kind of review and examination of the situation that would have led to trying to unravel it.

Mr. **Wyden**. Mr. Chairman, I see the gavel, and I wanted to see if I could get some questions on our generic drug investigation upstairs, and look forward to the next round.

Mr. **Dingell**. The Chair thanks the gentleman.

The time of the gentleman has expired.

The Chair now recognizes the distinguished gentleman from Minnesota, Mr. Sikorski?

Mr. **Sikorski**. Thank you, Mr. Chairman.

Let me commend GAO and all the work, the many hours put in, and for your assistance and fine work, which is a ritual around here, thanking GAO for its efforts.

Going back to where the gentleman from Oregon left off, after looking at this situation at Stanford, do you believe that once Stanford realized the Government was not, in effect, minding the store that they took advantage of the situation?

Mr. Socolar. I think it is fair to state that Stanford did take advantage of the situation.

Mr. Sikorski. The policy became one of "catch us if you can?"

Mr. Socolar. I can understand that characterization, too, yes.

Mr. Sikorski. I raised earlier the issue of this term "aggressive billing policy." It struck me as just wrong. One other term that—the gentleman from New York mentioned the "subsistence cost" issue.

Nine years ago, I was in charge of the welfare budget in the State of Minnesota, legislatively, and we had to cut about 10 percent of it, and since then, I have been here looking at cuts in safety-net programs and the rest of it, and I understand what "subsistence hunting" is for native Americans and Alaskan natives, and I understand what subsistence is for welfare recipients.

Can you explain to me, when we talk subsistence here for Stanford University, what we are talking about in that category of costs?

Ms. Eng. These would be the costs for food, catering for particular events on campus, alcoholic beverages, any types of food type items.

Mr. Sikorski. So when caviar is served or edible art is paid for catering a football lunch, that goes into this subsistence costs?

Ms. Eng. It is supposed to; that's correct.

Mr. Sikorski. Now, if it goes into subsistence—and it doesn't always end up in there; is that correct, Ms. Eng?

Ms. Eng. That's correct.

Mr. Sikorski. It ends up in other costs that are paid by the taxpayers; is that correct?

Ms. Eng. That's correct.

Mr. Sikorski. Now, if it goes into a subsistence cost category, what happens to it?

Ms. Eng. When it goes into subsistence, Stanford has an MOU with ONR that allows them, rather than tracking specific transactions, specific subsistence transactions as to the allowability or unallowability, they have an MOU that allows them just to deduct a straight 20 percent off the top of all subsistence, both allowable and unallowable, which is meant to represent the unallowable portion for the university as a whole.

Mr. Sikorski. So, $10,000 for wine and edibles and food and that stuff, 20 percent off the top is disallowed?

Ms. Eng. Correct.

Mr. Sikorski. $8,000 is put in for payment. As I understand it, of that $8,000 is it 25 percent under that MOU?

Ms. Eng. In the General and Administrative Cost Pool; that's about correct.

Mr. Sikorski. We don't pay for the appetizer, but we pay for the main course and dessert and the drinks with the 80 percent?

Ms. Eng. That's true, but you have to keep in mind that it's taken off all of the subsistence.

Mr. Sikorski. Now, this 20 percent is derived—how did that number get there?

Ms. **Eng**. Apparently, Stanford and the ONR, at the beginning of the MOU which was signed in 1979, went through some analyses to determine that roughly, over an historical period, about 20 percent of their total subsistence had to be deducted.

Mr. **Sikorski**. So they came up with a study that showed that. Now, have you asked for that study?

Ms. **Eng**. No, we did not pursue that particular one.

Mr. **Sikorski**. As I understand it, it's been lost and yet we continue to go along with that approach.

Mr. **Sikorski**. In this subsistence funding, you have a host of things going through here—wine and all kinds of food and the rest of it. How does that get called subsistence?

Ms. **Eng**. The individual departments who are recording these accounting transactions are supposed to code those to a subsistence general ledger account.

Mr. **Sikorski**. Now, is that a term that's derived from Navy or from defense contracting?

Ms. **Eng**. It is a specific account in Stanford's chart of accounts.

Mr. **Sikorski**. In Stanford's terminology?

Ms. **Eng**. Correct.

Mr. **Sikorski**. Now, tell me how the OMB circular treats entertainment expenses?

Ms. **Eng**. They are unallowable. But all of a sudden we have entertainment expenses being called subsistence expenses and after 20 percent are disallowed, 80 percent are allowable or allocable?

Ms. **Eng**. They are allocated to research through the G&A pool.

Mr. **Sikorski**. Do you see why I'm confused?

Ms. **Eng**. I do.

Mr. **Sikorski**. Thank you. Thank you, Mr. Chairman.

Mr. **Dingell**. The Chair thanks the gentleman. Let me ask you about these Memorandums of Understanding. Did you look at these Memorandums of Understanding? They have—what is it, 125 at Stanford?

Mr. **Socolar**. They have 90 active ones.

Mr. **Dingell**. Ninety active ones? How many do they have at the other colleges and universities in the United States?

Mr. **Socolar**. I don't know the answer to that question, offhand, but I think that the next highest number is 8.

Mr. **Dingell**. Where is that?

Mr. **Socolar**. I'm sorry, it's 13 at Cal Tech.

Mr. **Dingell**. Then?

Mr. **Socolar**. Seven at MIT.

Mr. **Dingell**. That's 15 at two universities and 90 active here and there have been 125 here. How many of these MOU's were reviewed by the auditing agencies or the granting agencies before they were signed?

Mr. **Socolar**. As far as I know, none of them were really reviewed and subjected to legal analysis.

Mr. **Dingell**. Do you find any evidence of any legal analysis here with regard to the MOU's?

Mr. **Socolar**. No.

Mr. **Dingell**. Do you find any evidence of legal analysis to MOU's at any of the other colleges and universities?

Mr. **Socolar**. We haven't looked at the other colleges at this point.

Mr. **Dingell**. Would I be fair in inferring that Stanford has more MOU's than any other college or university in the country?

Mr. **Socolar**. That's correct, yes.

Mr. **Dingell**. And more than all the rest of them put together?

Mr. **Socolar**. I'm not sure of that.

Mr. **Dingell**. Would you check that, please, for the record, to assist us?

Mr. **Socolar**. Sure.

Mr. **Dingell**. None of them, you say, were subject to legal analysis?

Mr. **Socolar**. That's correct.

Mr. **Dingell**. Had any of them been audited?

Mr. **Socolar**. Not that I'm aware of.

Mr. **Dingell**. Prior to the time that this committee began expressing interest?

Mr. **Socolar**. No. I think that audits are being undertaken now.

Mr. **Dingell**. But only since the committee got interested in these matters?

Mr. **Socolar**. That's correct.

Mr. **Dingell**. Prior to that time, none?

Mr. **Socolar**. That's correct.

Mr. **Dingell**. These Memorandums of Understanding all alter or relax the treatment of payment by the Federal Government to the college or university in such a way as to make it more favorable to the college or university; is that correct?

Mr. **Socolar**. Yes. The purpose of an MOU is really to depart from the basic guidelines in A-21.

Mr. **Dingell**. These are basically to get around Government regulations, particular the OMB Circular on these matters?

Mr. **Socolar**. Well, the Circular itself allows for them.

Mr. **Dingell**. I know it, but it's to get around the specific language of the Circular?

Mr. **Socolar**. Yes.

Mr. **Dingell**. Ms. Eng, you had a comment you wanted to make; what was it, please?

Ms. **Eng**. I was simply saying that we hadn't looked at all the MOU's. I can't say unequivocally that they all depart from A-21.

Mr. **Dingell**. Mr. Socolar, Ms. Eng, Mr. Ols, the committee is very appreciative. The Chair is going to ask; does the gentleman from Texas have additional questions?

Mr. **Bryant**. Yes.

Mr. **Dingell**. The gentleman is recognized.

Mr. **Bryant**. I'm more troubled by the possibility of intentional misleading of the Government by Stanford than I am of the money involved here. That's why I continue to pursue questions along those lines. I would like it if we could find that it was all a big accident.

Would you characterize, Mr. Socolar, whether or not Stanford was cooperative with your inquiry and the inquiries of members of your staff?

Mr. **Socolar**. As a general proposition, I would say they were cooperative. There were some periods in the course of our examination where there were delays and as I mentioned earlier, there is one document that has been denied to us. I have not examined the issue as to whether or not that denial is a justified denial.

Mr. **Bryant**. Ms. Eng, when the Comptroller told you there was no yacht, and then came back and told you there was a yacht, did he tell you that he was sorry that he had made a mistake that, indeed, there was a yacht, or did he admit to you that he had known along that there was a yacht.

Ms. **Eng**. They said it was a mistake.

Mr. **Bryant**. So he told you that the didn't know that the yacht existed?

Ms. **Eng**. That's correct.

Mr. **Bryant**. Thank you.

Mr. **Lent**. One more question, Mr. Chairman.

Mr. **Dingell**. The time of the gentleman has expired. The gentleman from New York, Mr. Lent.

Mr. **Lent**. Mr. Chairman, I think in the interest of time and moving on to the next panel, I do have questions, but I think I can ask the questions to the ensuing panels just as easily.

Mr. **Dingell**. Very well. Mr. Socolar, Ms. Eng, Mr. Ols, the committee is grateful to you for your assistance. The Chair advises we will be probably having additional questions. We will probably direct them to you in writing and we thank you for your assistance to the committee.

Mr. **Socolar**. Thank you, Mr. Chairman.

Mr. **Dingell**. The Chair announces that our next panel is a panel composed of Mr. Fred J. Newton, Deputy Director, Defense Contract Audit Agency; Mr. Robert Lloyd, Regional Audit Manager, Defense Contract Audit Agency for the Western Region; Mr. Arlin Tueller, Deputy Regional Director, Western Region, Defense Contract Audit Agency.

Mr. Newton, before we swear you in, we are going to wish you a happy birthday.

Mr. **Newton**. Thank you.

Mr. **Dingell**. The Chair will advise you that the rules of the committee do not permit us to sing "Happy Birthday."

Mr. **Newton**. Thank you.

Mr. **Dingell**. Gentlemen, the committee welcomes you. We thank you for your assistance to us. The Chair advises that copies of the rules of the subcommittee are there before you to inform you of your rights and the limitations on the powers of the committee. The Chair advises that since this committee was set up by the great Speaker, Sam Rayburn, that the rules and practices have always required that all witnesses testify under oath. Gentlemen, do you or any of you object to testifying under oath today?

[Chorus of no's.]

Mr. **Dingell**. Very well. The Chair advises that given this circumstance, you are entitled to be advised by counsel as you appear here before the committee. Do any of you desire to be represented by counsel as you appear here?

[Chorus of no's.]

Mr. **Dingell**. Very well, if you then have no objection to testifying under oath, will you each please rise and raise your right hand.

[Witnesses sworn.]

Mr. Dingell. Gentlemen, you may each consider yourselves under oath. The Chair will recognize you for such statement as you choose to give.

TESTIMONY OF FRED J. NEWTON, DEPUTY DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY, ACCOMPANIED BY ROBERT LLOYD, REGIONAL AUDIT MANAGER, WESTERN REGION, AND ARLIN R. TUELLER, DEPUTY REGIONAL DIRECTOR

Mr. Newton. Mr. Chairman, I have a formal statement which I would like to submit for the record.

Mr. Dingell. Very well, without objection, it will be inserted in the record. The Chair will recognize you, Mr. Newton for such statement as you choose to give.

Mr. Tueller and Mr. Lloyd, do you have prepared statements you would like to give or are you here just to respond to questions?

Mr. Tueller. No prepared statement.

Mr. Lloyd. No prepared statement.

Mr. Dingell. Very well. Then we will recognize you, Mr. Newton, for such comments as you choose to make and your prepared statement will be inserted in the record in full. You may proceed.

Mr. Newton. Thank you, Mr. Chairman and members of the subcommittee.

The Office of Management and Budget published OMB Circular A-21, which contains principles to be implemented by each Government agency in determining the costs of grants and contracts awarded to educational institutions for research and development or educational services. These principles have been implemented in the Federal Acquisition Regulations, which hereafter I will refer to as FAR, subpart 31.3, which is incorporated, by reference, in each applicable Department of Defense contract and grant.

DCAA auditors refer to the A-21 principles in audits at Stanford University. The principles contained in OMB Circular A-21 govern the allowability of both direct and indirect costs and they are similar in purpose to the principles for determining allowable costs applicable to contracts awarded to commercial organizations contained in the FAR subpart 31.2.

However, there are two important differences. First, the cost principles in OMB Circular A-21 are not as comprehensive or specific as those contained in the FAR. This allows for a much broader interpretation of the cost governed by the A-21 cost principles than is possible under the FAR cost principles.

Second, the FAR cost principles incorporate statutory cost prohibitions. For example, the FAR includes specific cost restrictions set forth in Public Law 99-145, which is the fiscal year 1986 Defense Authorization Act. This public law made certain costs, including alcoholic beverages and the costs of tickets to shows and sporting events, expressly unallowable. These statutory restrictions are not incorporated into the OMB Circular A-21. However, through interpretation, DCAA asserts that such costs may be reasonable classified as entertainment which is expressly unallowable in OMB Circular A-21.

Under provisions of both the FAR and OMB Circular A-21, the Government contracting officers and organizations receiving grants for contracts, may execute a Memorandum of Understanding, the MOU, which we have been referring to here today. They can do this on the treatment of certain costs.

Such memoranda reflect contractual interpretation and are expected to help avoid subsequent disputes regarding the allowability of cost. However, the execution of an MOU is not a requirement. The absence of an MOU will not, in itself, affect the allowability of the cost.

OMB Circular A-21 includes procedures for determining cost allocability. A cost is allocable to a particular cost objective, if there exists a causal beneficial relationship between the expense and the particular cost objective. Because indirect expenses are not identifiable to a specific cost objective, they must be grouped together and allocated to the various institutional functions and projects.

The overall objective of the indirect cost allocation process is to distribute the cost to the major functions and projects of the university, in proportions consistent with the nature and extent of their use of the university's resources.

To achieve this objective, it is often necessary to group like expenses together into cost pools and distribute them to the various functions and projects, using some equitable distribution base.

To accomplish this in a manner that ensures the Government bears only its fair share of the cost, OMB Circular A-21 establishes procedures to be used in grouping like expenses and specifies cost distribution methods which are appropriate for most circumstances.

The circular provides for the use of alternate distribution methods, when the use of a different method results in a more equitable allocation of the cost. I would like to emphasize here that the institution is responsible for demonstrating that the use of any alternate distribution method results in an equitable allocation of the cost to the Government.

The institution is required to make this demonstration through the use of cost analysis studies. The circular says, and I would like to quote: "The cost analysis studies must be appropriately documented in sufficient detail for subsequent review by the Federal agency." They "must distribute the cost to the related objectives in accordance with the relative benefits derived," it "must be statistically sound," it "must be performed specifically at the institution at which the results are to be used, and" finally, "must be reviewed and periodically updated by the institution for the Government, but not less frequently than every 2 years."

If a cost analysis study is not performed, or if the study does not show that the alternate allocation results in an equitable distribution of the cost, the distribution then must be made in accordance with methods specified in OMB Circular A-21.

As is the case concerning other matters affecting cost allowability, the Government and institutions often document their mutual understandings of the appropriate indirect cost allocation method to be used by executing an MOU. That condition exists in abundance at Stanford University. There are about 125 MOU's between Stanford University and the Office of Naval Research, ONR. This is about 10 times as many at other universities we audit. It should be noted that 12 of these MOU's affect over 80 percent of the indirect cost allocated to the Government.

Focusing now on DCAA's audit involvement at Stanford University. In executing our mission responsibilities, DCAA audits cost allowability, which includes allocability considerations. It is DCAA's policy to advise the cognizant contracting officer of any cost analysis study or MOU, which the auditor believes results in an inequitable treatment or distribution of cost, or is otherwise not in the Government's best interest and to recommend revisions.

When requested, this audit advice is provided to the contacting officer before the memoranda are executed. Otherwise, the advice is provided as observations are made during the routine course of audit performance.

Stanford's indirect cost recovery practices for Federal research grants and contracts and its compliance with applicable Federal laws and regulations has been the subject of considerable scrutiny over the past several months. For example, DCAA's audit activity has usually been accomplished by 2 or 3 auditors from our Redwood Branch Office in Sunnyvale, Calif.

We have temporarily placed 20 auditors at Stanford. This increased audit activity is due to aggressive action on audit recommendations by an ONR contracting official, Mr. Paul Biddle, and the attention being given to audit disclosures by various Government organizations, including your subcommittee. In other words, we are taking advantage of the opportunity to get corrective action on issues our auditors have been wrestling with for some time.

A variety of complex events and circumstances have adversely affected audits at Stanford during the past 10 years. Most significant is the prolific use of Memoranda of Understanding affecting cost determination and Stanford's use of the alternate allocation procedures without satisfactory analytical support.

By going through the chronology of years and related audits, I believe you will see the difficult situation faced by the DCAA auditors.

Our audit of 1980 cost—this was before the significant MOU allocation procedures went into effect, resulted in questioned costs of about $1.2 million. ONR negotiated then a reduction of only $400,000. We were not provided details of the negotiation.

On May 3, 1985, ONR entered into an agreement with Stanford to waive audits for 1981 and 1982, subject to the outcome of an audit of 1983, incurred costs. The agreement stipulates a $400,000 downward adjustment for those years 1981 and 1982.

In a February 8, 1985 response to ONR's request for comments on the draft agreement, DCAA requested that Stanford be required to provide the basis of the $400,000 negotiated amount. The results were not provided. However, the final agreement includes a reopener clause suggested by DCAA. By terms of the agreement, audits of 1981 and 1982 cannot begin though, unless 1983 is settled with a negotiated reduction in excess of $400,000.

The audit of 1983 cost was initially concluded and reported on in April, 1987. Its completion was delayed primarily because of audit staffing shortages during the period of significant increases in Defense expenditures in the early 1980's. The staffing shortage was relieved beginning in Government fiscal year 1987.

Negotiations of the report on 1983 claim costs were not concluded before additional concerns were identified in audits of subsequent years. The auditor issued a supplemental report in September, 1990, where the total questioned cost is about $5 million.

Some examples of questioned amounts are: $318,000 incurred in support of the campus Student Union activity—this is expressly unallowable as a charge to the Government; $284,000 incurred by the School of Medicine as new faculty salaries and miscellaneous expenses charged inappropriately to the Government as operation maintenance.

The audits of 1984, 1985 and 1986 incurred costs were performed simultaneously and reports were issued in August, 1990. About $5 million of cost claimed was questioned in each year.

Some examples of questioned amounts are: $525,000 incurred as computer system use in fundraising activities. This is expressly unallowable as a charge to the Government; $249,000 of revenue was not applied as a credit to parking lot expenses which were charged to the Government.

DCAA audits of Stanford's 1987 and 1988 incurred cost submissions are underway. These audits include comprehensive transaction testing of all sensitive accounts and analysis of all applicable MOU's. Ongoing audit testing indicates a large number of allocability and allowability issues as well as deficient financial and internal controls.

Three examples are representative of numerous allowability issues being disclosed in this audit. The audit has identified personal laundering services in the university president's subsistence account in the amount of $1,530. This is just one transaction. It is a recurring expense. Alcoholic beverages for various commencement activities in the amount of $1,754—this too is just one transaction. It is a recurring expense. Expenses for a Lake Tahoe retreat for the University Board of Trustees in the amount of $45,000—in the case of the Lake Tahoe retreat, Stanford has denied access to the supporting documentation. Access would be useful to us in identifying other related unallowable costs. We are continuing to pursue access to this information.

Stanford has not submitted its claims for incurred costs for 1989 and 1990. Federal Acquisition Regulation 52.216-7 applies to Stanford and requires that certified cost claims be submitted within 90 days after the close of the institution's fiscal year. Stanford's fiscal year closes August 31. Therefore, the 1989 and 1990 submissions are 15 and 3 months delinquent, respectively.

Virtually all of Stanford's indirect costs are distributed based on alternative procedures set forth in Memoranda of Understanding. Until recently, DCAA has typically not been requested to review the cost analysis studies and MOU's prior to their execution. However, when subsequently reviewed in conjunction with incurred costs and other audits, cost analyses have often shown that the alternative methods generate inequitable distributions of cost and therefore are not in the Government's best interest.

Further, the March 8, 1991 audit report on Stanford's proposed 1991 forward pricing rates recommends a 52 percent billing rate for the recovery of indirect expenses compared to Stanford's proposed rate of 76 percent. The report takes exception to the inequitable cost allocations in the area of library, department administration, student services, and utilities as well as expressly unallowable and misclassified costs. The report states that Stanford has not performed cost analysis studies required by OMB circular A-21, identifies major unsettled issues in existing MOU's and recommends that the MOU's be amended to correct inequities.

Given the numerous times DCAA has taken exception to the Stanford MOU's we recommended on February 19, 1991 that all MOU's be cancelled. DCAA has consistently stated in reports and other correspondence that Stanford has not fulfilled its obligation to support alternative cost allocation methods. It is not the auditor's responsibility to justify Stanford's cost allocations and MOU's. The auditor is responsible for evaluating cost study analyses submitted by the university supporting the alternative cost allocation methods. DCAA auditors conclude that Stanford is not in compliance with the requirements of A-21 regarding cost study analyses.

The magnitude of the problem of Stanford varies from year to year and in some cases are not quantifiable. As I mentioned previously, the most recent year for which audits are completed resulted in cost questions of about $5 million in each year. We have heard of a Government estimate of $200 million of overcharges in the last decade but that is not a DCAA estimate.

The impact is significant though, whatever the amount. It is significant because of the enormous consumption of Government resources in excess of what would be required if Stanford University would install systems and controls to assure that its billings to the Government conform with applicable regulations.

Stanford has acknowledged the existence of shortcomings in its accounting system. An independent consulting organization has been retained by Stanford to assist the efforts to correct the accounting and internal control deficiencies. I view this as a positive step. That's the good news.

The bad news is that on-site auditors report that Stanford University representatives have not been cooperative in the audit process. The university requires substantial and time-consuming justification before responding to requests for data.

For example, on February 27, 1991, DCAA auditors asked Stanford Operation and Management Department personnel for the historical utility meter-reading usage records. The information is needed for a routine test of utility cost allocations. Access to the record was denied, purportedly pending a review by the Stanford Comptroller's office staff. I have no idea what they would do with it.

We have instructed our General Counsel to consult with the onsite auditors on the access issues. This will include assuring that access requests include only data required for audits. That is currently being done. Stanford has written to the DCAA Audit Manager on March 7, 1991 indicating interest in meeting to work out mutually satisfactory procedures for requesting and providing information needed in the audit process. We are hopeful that that meeting will be effective in having Stanford remove barriers to cooperation and efficient audits.

Turning to the actions being taken by DCAA at other educational institutions, as a direct result of issues raised at Stanford University a comprehensive university audit risk assessment was performed at all educational institutions where DCAA has audit responsibility. This request was initiated in October 1990 and covered 40 colleges and universities.

The results did not disclose any other university with the magnitude of significant high risk situations as exist at Stanford. In fact, there are some major universities exerting special effort to assure proper practice.

However, there were several situations identified which require audit follow-up. DCAA headquarters is closely monitoring these efforts. Follow-up action by DCAA offices are resulting in disclosure of some questionable practices at the other institutions.

For example, as a result of questions raised by DCAA during the 1987 and 1988 incurred cost audits, one university recently withdrew over $500,000 of claimed expenses from three selected accounts for the years 1987 through 1990.

In conclusion, significant concern has been voiced by auditors regarding the lack of specificity and ambiguous wording in the OMB circular A-21. DCAA performed an analysis with extensive field input. Our analysis has recently been forwarded to DOD management officials for their continuing coordination with OMB.

Mr. Chairman and members of the subcommittee, this concludes my remarks. My colleagues and I would be glad to try to answer any questions.

[Testimony resumes on p. 86.]

[The prepared testimony of Mr. Newton follows:]

Statement of

Fred J. Newton

Deputy Director

Defense Contract Audit Agency

Good morning Mr. Chairman and members of the subcommittee. As you have requested, I will describe activities of the Defense Contract Audit Agency (DCAA) in auditing costs billed by Stanford University to federal grants and contracts. Accompanying me to assist in responding to any questions you may have are two senior managers from DCAA's Western Regional Office, which has cognizance of audits at Stanford University. They are Mr. Arlin Tueller, Deputy Regional Director, and Mr. Robert Lloyd, the Regional Audit Manager responsible for oversight of the DCAA field office which performs audits at Stanford.

To begin, I will give a brief overview of the government audit role at educational institutions, as established by applicable OMB Circulars and Regulations, and describe the procedures for determining the allowability, allocability and reasonableness of costs. Then I will address DCAA's audit activity at Stanford University. Also, I will identify the actions being taken by DCAA at other institutions to identify areas of current sensitivity or risk.

The Office of Management and Budget (OMB), through the issuance of circulars, controls interagency arrangements for the assignment of contract audit and negotiation cognizance at educational institutions, establishes principles to be used in determining the costs of grants and contracts, and establishes audit requirements for educational institutions that receive federal awards. Three such circulars are of particular importance:

OMB Circular A-88 establishes DCAA as the cognizant audit agency and the Department of Navy as the cognizant entity for contract administration for a number of institutions, including Stanford University.

OMB Circular A-21 contains principles to be implemented by each government agency in determining the costs of grants and contracts awarded to educational institutions for research and development or educational services. These principles have been implemented in the Federal Acquisition Regulations (FAR) subpart 31.3, which is incorporated by reference in each applicable Department of Defense contract and grant.

OMB Circular A-133 establishes audit requirements and defines federal responsibilities for implementing and monitoring such requirements for educational institutions and other nonprofit institutions receiving federal awards.

Again, OMB Circular A-21 establishes principles for determining costs applicable to grants, contracts, and other agreements with educational institutions. These agreements are referred to as sponsored agreements. The principles deal with the subject of cost determination and allowability. They provide for the federal government to bear its fair share of total costs, determined in accordance with generally accepted accounting principles, except where restricted or prohibited by law. The successful application of the cost accounting principles requires the development of a mutual understanding between representatives of educational institutions and the federal government as to their scope, implementation, and interpretation.

Costs associated with grants, contracts, and other sponsored agreements can be categorized as either direct costs or indirect costs. Direct costs are those costs that can be identified specifically with a particular sponsored project, an instructional activity, or any other institutional activity; or that can be directly assigned to such activities with relative ease and accuracy.

By contrast, indirect costs are those that are incurred for common or joint objectives and cannot practically be identified with a specific sponsored project, instructional activity, or other institutional activity. The costs that have been the subject of your subcommittee's recent inquiries are indirect costs. At educational institutions, such costs are normally classified into cost categories such as depreciation and use allowances, general administration and general expenses, sponsored projects administration expenses, operation and maintenance expenses, library expenses, departmental administration expenses, and student administration and services.

The principles contained in OMB Circular A-21 governing the allowability of both direct and indirect costs are similar in purpose to the principles for determining allowable costs applicable to contracts awarded to commercial organizations contained in the FAR subpart 31.2. However, there are two important differences. First, the cost principles in OMB Circular A-21 are not as comprehensive or specific as those contained in the FAR. This allows for a much broader interpretation of the costs governed by the A-21 cost principles than is possible under the FAR cost principles.

Secondly, the FAR cost principles incorporate statutory cost prohibitions. For example, the FAR includes specific cost restrictions set forth in Public Law 99-145, the FY 1986 Defense Authorization Act. This public law made certain costs, including alcoholic beverages and the costs of tickets to shows and sporting events, expressly unallowable. These statutory restrictions are not incorporated into the OMB Circular A-21.

Under provisions of both the FAR and OMB Circular A-21, the government contracting officers and organizations receiving grants or contracts may execute a memorandum of understanding (MOU) on the treatment of certain costs. Such memoranda reflect contractual interpretation and are expected to help avoid subsequent disputes regarding the allowability of costs. However, the execution of an MOU is not a requirement. The absence of a MOU will not, in itself, affect the allowability of the cost.

OMB Circular A-21 includes procedures for determining cost allocability. A cost is allocable to a particular cost objective (i.e., a specific function, project, sponsored agreement, department, or the like) if there exists a causal/beneficial relationship between the expense and the particular cost objective. For example, a cost is allocable to a sponsored agreement if it is incurred solely to advance the work under the agreement; it benefits both the sponsored agreement and other work of the institution; or it is necessary to the overall operation of the institution.

Because indirect expenses are not identifiable to a specific cost objective, they must be grouped together and allocated to the various institutional functions and projects. The overall objective of the indirect cost allocation process is to distribute the costs to the major functions and projects of the university in proportions consistent with the nature and extent of their use of the university's resources. To achieve this objective, it is often necessary to group like expenses together into costs pools and distribute them to the various functions and projects using some equitable distribution base. To accomplish this in a manner that insures that the government bears only its fair share of the costs, OMB Circular A-21 establishes procedures to be used in grouping like expenses and specifies cost distribution methods which are appropriate for most circumstances.

The Circular provides for the use of alternate distribution methods when the use of a different method results in a more equitable allocation of the costs. The institution is responsible for demonstrating that the use of any alternative distribution method results in an equitable allocation of the costs to the government. The institution is required to make this demonstration through the use of cost analysis studies. The Circular says that:

- the costs analysis studies must be appropriately documented in sufficient detail for subsequent review by the cognizant federal agency,

- must distribute the costs to the related objectives in accordance with the relative benefits derived,

- must be statistically sound,

- must be performed specifically at the institution at which the results are to be used, and

- must be reviewed and periodically updated by the institution for the government; but not less frequently than every two years.

If a cost analysis study is not performed, or if the study does not show the alternate allocation results in an equitable distribution of the costs the distribution must be made in accordance with methods specified in OMB Circular A-21.

As is the case concerning other matters affecting costs allowability, the government and institutions often document their mutual understanding of the appropriate indirect cost allocation method to be used by executing an MOU.

That condition exists at Stanford University. There are about 125 MOUs between Stanford University and the Office of Naval Research (ONR). It should be noted that 12 of these MOUs affect over 80 percent of the indirect costs allocated to the government.

In executing our mission responsibilities, DCAA audits cost allowability, which includes allocability considerations. It is DCAA's policy to advise the cognizant contracting officer of any cost analysis study or MOU which the auditor believes results in an inequitable treatment or distribution of costs, or is otherwise not in the government's best interest, and to recommend revisions. When requested, this audit advice is provided to the contracting officer before the memoranda are executed. Otherwise, the advice is provided as observations are made during the routine course of audit performance.

Focusing now on DCAA's audit involvement at Stanford University:

OMB Circular A-88 establishes DCAA as the cognizant audit agency, and the Office of Naval Research (ONR) as the cognizant contracting entity for the administration of Federal grants and contracts at Stanford University.

Stanford's indirect cost recovery practices for federal research grants and contracts and its compliance with applicable federal laws and regulations has been the subject of considerable scrutiny over the past several months. For example, DCAA's audit activity has usually been accomplished by 2 or 3 auditors from our Redwood Branch Office in Sunnyvale, California. We have temporarily placed 20 auditors at Stanford. This increased audit activity is due to aggressive action on audit recommendations by an ONR contracting official, Mr. Paul Biddle, and the attention being given to audit disclosures by various government organizations, including your subcommittee. In other words, we are taking advantage of the opportunity to get corrective action on issues our auditors have been wrestling with for some time.

A variety of complex events and circumstances have adversely affected audits at Stanford during the past 10 years. Most significant is the prolific use of memoranda of understanding affecting cost determination and Stanford's use of alternative allocation procedures without satisfactory analytical support. By going through the chronology of years and related audits, I believe you will see the difficult situation faced by the DCAA auditors.

On 3 May 1985, ONR entered into an agreement with Stanford to waive audits for 1981 and 1982, subject to the outcome of an audit of 1983 incurred costs. The agreement stipulates a $400,000 downward adjustment for 1981 and 1982. In an 8 February 1985 response to ONR's request for comments on the draft agreement, DCAA requested that Stanford be required to provide the basis of the $400,000 negotiated amount. The results were not provided. However, the final agreement includes a reopener clause suggested by DCAA. By terms of the agreement, audits of 1981 and 1982 cannot begin unless 1983 is settled with a negotiated reduction in excess of $400,000.

The audit of 1983 costs was concluded and reported on in April 1987. Its completion was delayed primarily because of audit staffing shortages during the period of significant increases in defense expenditures in the early 1980s. The staffing shortage was relieved beginning in government fiscal year 1987. Negotiations of the report on 1983 claimed costs were not concluded before additional concerns were identified in audits of subsequent years. The auditor issued a supplemental report in September 1990. The total questioned is about $5 million. Some examples of questioned amounts are:

1. $318,000 incurred in support of the campus student union activity. This is expressly unallowable as a charge to the government.

2. $284,000 incurred by the School of Medicine as new faculty salaries and miscellaneous expenses, charged inappropriately to the government as operation maintenance.

The audits of 1984, 1985, and 1986 incurred costs were performed simultaneously and reports were issued in August 1990. About $5 million of costs claimed was questioned in each year. Some examples of questioned amounts are:

1. $525,000 incurred as computer system use in fund raising activities. This is expressly unallowable as a charge to the government.

2. $249,000 of revenue was not applied as a credit to parking lot expenses charged to the government.

DCAA audits of Stanford's 1987 and 1988 incurred cost submissions are underway. These audits include comprehensive transaction testing of all sensitive accounts and analysis of all applicable MOUs. Ongoing audit testing indicates a large number of allocability and allowability issues and deficient financial and internal controls. Three examples are representative of numerous allowability issues being disclosed:

1. The audit has identified personal laundering services in the University President's subsistence account in the amount of $1,530;

2. Alcoholic beverages for various commencement activities in the amount of $1,754; and

3. Expenses for a Lake Tahoe retreat for the University Board of Trustees in the amount of $45,000. In the case of the Lake Tahoe retreat, Stanford has denied access to the supporting documentation. Access would be useful in identifying other related unallowable costs. We are continuing to pursue access to this information.

The above expenses do not appear to benefit government sponsored research. These audits are expected to be completed in September 1991.

Stanford has not submitted its claims for incurred costs for 1989 and 1990. Federal Acquisition Regulation 52.216-7 applies to educational institutions and requires that certified cost claims be submitted within 90 days after the close of the institution's fiscal year. Stanford's fiscal year closes 31 August. Therefore, the 1989 and 1990 submissions are 15 and 3 months delinquent, respectively.

Virtually all of Stanford's indirect costs are distributed based on alternative procedures set forth in memoranda of understanding. Until recently, DCAA has typically not been requested to review the cost analysis studies and MOUs prior to their execution. However, when subsequently reviewed in conjunction with incurred costs and other audits, cost analyses have often shown that the alternative methods generate inequitable distributions of costs and, therefore, are not in the government's best interest.

DCAA has communicated its concern about MOUs to on-site ONR officials in the 1983 through 1986 incurred cost audit reports. Also, in a 28 September 1990 audit report on the review of Stanford's library studies, the auditor advised that the cost allocations are inequitable.

Further, the 8 March 1991 audit report on Stanford's proposed 1991 forward pricing rates recommends a 52 percent billing rate for the recovery of indirect expenses compared to Stanford's proposed rate of 76 percent. The report takes exception to inequitable cost allocations in the areas of library, department administration, student services and utilities, as well as expressly unallowable and misclassified costs. The report states that Stanford has not performed cost analysis studies required by OMB Circular A-21, identifies major unsettled issues in existing MOUs, and recommends that the MOUs be amended to correct inequities.

Given the numerous times DCAA has taken exception to the Stanford MOUs, we recommended on 19 February 1991 that all MOUs be cancelled. DCAA has consistently stated in reports and other correspondence that Stanford has not fulfilled its obligation to support alternative cost allocation methods. It is not the auditor's responsibility to justify Stanford's cost allocations and MOUs. The auditor is responsible for evaluating cost study analyses submitted by the university supporting the alternative cost allocation methods. DCAA auditors conclude that Stanford is not in compliance with the requirements of OMB Circular A-21 regarding cost study analyses.

The magnitude of the problems at Stanford varies from year-to-year and in some cases are not quantifiable. As I mentioned previously, the most recent years for which audits are complete resulted in costs questioned of about $5 million in each year. We have heard of a government estimate of $200 million of overcharges in the last decade, but that is not a DCAA estimate. The impact is significant, whatever the amount. It is significant because of the enormous consumption of government resources in excess of what would be required if Stanford University would install systems and controls to assure that its billings to the government conform with applicable regulations.

Stanford has acknowledged the existence of shortcomings in its accounting system. An independent consulting organization has been retained by Stanford to assist the efforts to correct accounting and internal control deficiencies. I view this as a positive step.

The on-site auditors report that Stanford University representatives have not been cooperative in the audit process. The university requires substantial and time consuming justification before responding to requests for data. For example, on 27 February 1991, DCAA auditors asked Stanford Operation and Management Department personnel for the historical utility meter reading usage record. The information is needed for a routine test of utility cost allocations. Access to the record was denied, purportedly pending a review by the Stanford controller's office staff.

We have instructed our General Counsel to consult with the on-site auditors on the access issues. That is currently being done. Stanford has written to the DCAA audit manager on 7 March 1991 indicating interest in meeting to work out mutually satisfactory procedures for requesting and providing information needed in the audit process.

I would now like to discuss the actions being taken by DCAA at other educational institutions under our audit cognizance to identify risk areas and other current sensitivities.

As a direct result of issues raised at Stanford University, a comprehensive university audit risk assessment was performed at all educational institutions where DCAA has audit responsibility. This request was initiated in October 1990 and covered forty colleges and universities.

The risk assessment included gathering information on the institution's basic organizational structure; identifying all external, internal, state and local, and other Federal auditors who may be providing audit oversight; and identifying and assessing the risk associated with all existing MOUs or other advance agreements.

The risk assessments were completed in December 1990 and were furnished to the Office of Naval Research Headquarters, GAO, and DCAA Regional Offices.

The results did not disclose any other university with the magnitude of significant high risk situations as exist at Stanford. However, there were several situations identified which require audit follow up. DCAA Headquarters is closely monitoring these efforts. Follow up actions by DCAA offices are resulting in disclosure of some questionable practices at other institutions. For example, as a result of questions raised by DCAA during the 1987 and 1988 incurred cost audits, one university recently withdrew over $500,000 of claimed expenses from three selected accounts for the years 1987 through 1990.

Significant concern has been voiced by field auditors regarding the lack of specificity and ambiguous wording in the OMB Circular A-21. DCAA performed an analysis with extensive field input. Our analysis has recently been forwarded to DoD management officials for their continuing coordination with OMB.

Our overall conclusion is that the circular should be revised in the interest of establishing uniform regulatory guidance to the maximum extent possible between commercial and noncommercial entities. Differences between commercial and noncommercial cost principles have led to the unfortunate predicament of having one set of cost principles for DoD contracts and another set for all grants and civilian contracts. This imposes an administrative burden on government contracting and auditing personnel and contractor personnel who are responsible for segregating allowable/unallowable costs of contracts versus grants within an entity which receives multiple federal awards.

Mr. Chairman and members of the subcommittee, this concludes my prepared remarks. I will be glad to answer any questions.

Mr. **Dingell**. Mr. Newton, the committee thanks you for a very helpful and very complete statement.

The Chair will now recognize members for questions commencing with my good friend from Georgia, Mr. Rowland.

Mr. **Rowland**. Thank you very much, Mr. Chairman. Thank you, Mr. Newton, for your statement.

Mr. Newton, the Defense Contract Audit Agency performs work at the request or the behest of various Defense Department representatives, registered representatives and so forth, is that not correct?

Mr. **Newton**. Yes, sir.

Mr. **Rowland**. Well, during the 1980's was the DCAA ever called in by the Navy to review the charging practices at Stanford, the adequacy of their accounting system and internal controls or to perform any transaction testing?

Mr. **Newton**. We did some auditing during the 1980's but not of the allocation procedures that are the subject of the memorandums of understanding. We were not asked to audit those.

Mr. **Rowland**. Well, what about transaction testing?

Mr. **Newton**. We have a responsibility, an ongoing responsibility to review vouchers but we did not have a specific request from the ONR to do such testing.

Mr. **Rowland**. Well, in addition, the Navy signed upwards I understand of about 125 MOU's with Stanford. Navy rules state that a formal audit is to be done prior to the signing of any of these MOU's. Of 125 or so with Stanford, how many DCAA audits prior to their implementation were done prior to this?

Mr. **Newton**. None.

Mr. **Rowland**. None? Well, is it fair to say for the large part that during the 1980's the Navy was negotiating with Stanford and administering contracts with Stanford effectively leaving its auditors on the sidelines?

Mr. **Newton**. We believe that it would have been more appropriate for DCAA to have had an opportunity to comment on the proposed allocation procedures beforehand.

Mr. **Rowland**. It's almost a requirement, isn't it, that——

Mr. **Newton**. Well, you have cited a Navy requirement that does not apply to bringing DCAA independently.

Mr. **Rowland**. I yield to the chairman.

Mr. **Dingell**. What input did you have to the MOU's at DCAA?

Mr. **Newton**. The input—I need to correct one point. There was one MOU that we were asked to audit in advance that I was not aware of.

The input that we have on them is nonexistent. We were not given a request to review an allocation justification presented by the contractor.

Mr. **Dingell**. The one instance to which you alluded related to an environmental issue. It did not relate to a question of charging, did it?

Mr. **Newton**. Yes, sir, it was an MOU related to that subject. So in response to the prior question as it related to MOU's, there was one that was evaluated prior to implementing.

Mr. **Dingell**. Did it relate to money?

Mr. **Newton**. There were no funds involved.

Mr. Dingell. So you were never consulted on any MOU with regard to money, were you?

Mr. Newton. That's correct.

Mr. Dingell. And there was never any question which was directed at any of the auditing agencies or any of the legal agencies with regard to opinions on these MOU's before they were negotiated, was there?

Mr. Newton. That's correct.

Mr. Dingell. Just curious—why were you left on the sidelines?

Mr. Newton. We wonder that ourselves, Mr. Chairman.

Mr. Dingell. The gentleman from Georgia is wondering why you were left on the sidelines. I am wondering why you were left on the sidelines. I am trying to understand how you can have good auditing or good execution of MOU's or good results from these memorandums of understanding without having the auditors or the legal people consulted.

Mr. Newton. We have never received an explanation from anyone that would satisfy myself as to why the auditor was not included. The only thing one can do is speculate as to whether there was a degree of trust being given that was unwarranted.

Mr. Dingell. Thank you, and the Chair thanks the gentleman for his kindness to me.

Mr. Rowland. I thank the chairman.

Mr. Newton, the DCAA has reviewed MOU's between Stanford and the Navy and has recommended their immediate termination. I believe you said this in your statement earlier.

Mr. Newton. That is correct, sir. Yes.

Mr. Rowland. Can you explain to us the basis for this recommendation and give us an estimate of how much DCAA believes these MOU's are costing the Government?

Mr. Newton. To the extent of our ongoing review of the alternate allocation procedures that are prescribed in the MOU's, we have not identified any where the allocation does not result in greater cost being allocated to the Government.

The criteria, as I read the Circular A-21—and let me qualify here that I am not a lawyer. I am an auditor, as opposed to a lawyer, but my reading of the criteria is that the alternative allocation procedures are only to be pursued where there has been a cost study analysis which would indicate that there are inequitable cost allocations resulting.

It would appear to me that the criteria that has been applied, as to what is equity, is what would bring more cost to the Government for reimbursement to Stanford, enhancing the revenues of Stanford University.

Mr. Rowland. Well, you mentioned a cost study analysis. Did Stanford have a cost study analysis that was reliable and accurate?

Mr. Newton. No, sir. We have not seen it if they have one. We would very much like to see the cost study analyses that would support any of their use of alternative cost allocation procedures. That is why we think that all of the MOU's ought to be thrown out.

There are prescribed allocation procedures within Circular A-21, which we commonly refer to as the default procedures.

They are generally considered acceptable as allocation approaches within the university environment. If there is something wrong with one of them insofar as what the result would be at a particular institution, Circular A-21 gives the university an opportunity to come forward with a very well-justified and well-documented study which would prove that there are inequities. I would expect inequities would go either way.

Mr. ROWLAND. Well, let me ask you this, then. Do you believe these MOU's may be costing the Government upwards of $20 million a year?

Mr. NEWTON. We have been able to—for 1 year, based on the projected costs for 1991. We have had an opportunity to look at what would be the difference between an allocation using the default procedures of A-21—the procedures that are prescribed under the A-21—and we would, based on that analysis, in relation to what the contractor had proposed for fiscal year 1991, come up with a difference of about $21 million that would be related to the Government's portion.

Mr. ROWLAND. Well, your current forward pricing audit supports an overhead rate of 52 percent versus the 76 percent that Stanford proposed. Do you believe that this is a good indicator of Stanford overcharges?

Mr. NEWTON. Yes, I do.

Mr. ROWLAND. So, now we are talking about something in the neighborhood of $30 million then.

Mr. NEWTON. For this year, the total that we have questioned there includes items of expressly unallowable costs, in addition to the MOU allocation items. It is about $28 million, close to $30 million in total. $21 million is the portion which I would say is reflective of the inappropriate allocations as a result of their using the Memorandum of Understanding approaches.

Mr. ROWLAND. Would this be about that much money taken out of the research pool, then?

Mr. NEWTON. Yes, sir.

Mr. ROWLAND. There is one other question that I would like to ask you at this point. Is Stanford typical of findings of DCAA around the country?

Mr. NEWTON. In the university environment, it is not. It is not reflective of what we are finding in the other universities when we audit.

Insofar as companies in general over the years, what we seem to be observing in this audit effort underway now is similar to those conditions, which I consider to be very abusive conditions, that were existing during the early 1980's. Some of the contractors have been mentioned here, at which there were great problems.

Mr. ROWLAND. General Dynamics?

Mr. NEWTON. General Dynamics, I think, is a very good example of a company where there were significant problems but for which they have done a great deal to correct the systems that caused those problems.

We have seen a lot of corrective action taking place in American industry, positive efforts toward assuring that the costs being charged to the Government are more closely scrutinized. But, we are not seeing that at Stanford.

Mr. **Rowland**. Let me ask you this. Would you draw a parallel between Stanford and General Dynamics?

Mr. **Newton**. I would draw a parallel between General Dynamics of the early 1980's and the other major contractors who were abusing the Government contracts, yes, sir.

Mr. **Rowland**. Is Stanford worse than General Dynamics today?

Mr. **Newton**. There was more money at General Dynamics. So, I would have to say that it was worse.

Mr. **Rowland**. Let me ask you one other question, then I will yield back, Mr. Chairman.

How would you describe the potential for overbilling at Stanford—high, medium, or low risk?

Mr. **Newton**. I would consider it a high risk, sir.

Mr. **Rowland**. Thank you, Mr. Chairman.

Mr. **Dingell**. The Chair thanks the gentleman.

The Chair recognizes now the distinguished gentleman from New York, Mr. Lent.

Mr. **Lent**. Thank you.

Mr. Newton, I understand that, looking at page 4 of your testimony, the distinction you make between OMB Circular A-21 and the Federal Acquisitions Regulations, or FAR, in that FAR includes specific cost restrictions, for example, on alcohol, while A-21 is more general.

My first question is, do both A-21 and FAR apply at Stanford?

Mr. **Newton**. The A-21 applies to Stanford by incorporation in the FAR. It is the provision of cost principles which apply specifically to Stanford.

Mr. **Lent**. OK. That means, for example, that alcohol is expressly unallowable. Is that correct?

Mr. **Newton**. In my opinion, through application of interpretation of the provisions of A-21, it is expressly unallowable. I have not seen instances where alcoholic beverages have been used in other than a social or entertainment environment. Stanford has not made any effort to come forward to support them as medicinal purposes or some other sort of allowable activity.

Mr. **Lent**. Let me help you out. I am reading from a list provided by the GAO of certain costs submitted by Stanford, and I would ask if you could please tell me whether, in your opinion, these are legitimate allowable costs; $1,050 to Beltranos for liquor at a wedding reception—would that be an allowable cost?

Mr. **Newton**. No, sir, I do not believe it would be.

Mr. **Lent**. Could there be any justification for it?

Mr. **Newton**. I have never seen anything that would.

Mr. **Lent**. Is $565 to K&L Wines and Liquors for cognac, wine, and champagne at the university lake house—could that be an allowable, legitimate cost?

Mr. **Newton**. No, it would not.

Mr. **Lent**. Is there any justification that you can think of for that expense?

Mr. **Newton**. I cannot imagine any that could be brought forward for that.

Mr. **Lent**. Turning to OMB Circular A-21 again for just a moment, are commencement activities allowable costs?

Mr. **Newton**. Commencement activities are expressly unallowable under A-21.

Mr. **Lent**. So, that means that a bill to Marriott in the amount of $11,050 for catering, including 250 gallons of wine punch and 2,000 slices of nut bread, would be expressly unallowable. Is that correct?

Mr. **Newton**. Yes, sir.

Mr. **Lent**. How do you think these expressly unallowable items ended up in the cost pool? I mean, should not Stanford have known that these items were unallowable?

Mr. **Newton**. I believe they end up in the cost pool by there being no significant effort that we can discern to establish a system for identifying and excluding expressly unallowable costs.

Mr. **Lent**. So, you are saying that Stanford really had no system for weeding out unallowable costs.

Mr. **Newton**. That is correct.

Mr. **Lent**. Now, why would Stanford want to enter into so many MOU's, and why would ONR agree with Stanford's requests to do so?

Mr. **Newton**. Since all of the MOU's which we have examined result in alternative allocation procedures which cost the Government more money, increasing the revenues to Stanford University, I can only speculate here that the motivation is to increase revenues to Stanford University, to be able to recover more from the Government through the contracts and grants.

That is my speculation about what they have done, but I do not know what their intentions were behind it. I do not see money going both ways. If I saw some going in favor of the Government, some going in favor of Stanford, then I would say there may be some merit to it.

Mr. **Lent**. So that, so far as you can discern in examining the Stanford ONR MOU's, there was or is a specific monetary advantage that comes to the university from each MOU.

Mr. **Newton**. Absolutely.

Mr. **Lent**. In your testimony, you talk about a $400,000 downward adjustment for 1981 and 1982. How was this figure arrived at?

Mr. **Newton**. We have asked the ONR and Stanford to give us a breakdown of what that amount would be, and we have not received a response to that request.

Mr. **Lent**. Can you tell us specifically who you asked, and how you might have followed upon this request?

Mr. **Newton**. I will ask Mr. Lloyd here, since he is in the field doing the audits there.

Mr. **Lent**. Mr. Lloyd, my question really is whether your Agency requested Stanford provide the basis of this figure, and whether those results were forthcoming.

Have you followed up on this, what reason, if any, did Stanford give for not providing this information, and have there been any other occasions where information requested from Stanford has been withheld?

Mr. **Lloyd**. You are asking several questions. You first asked for the breakdown of the $400,000. The prior ACO at Stanford, when he negotiated that $400,000, we didn't get any answer on that. From that time on, we followed up in the last several years with the then-present ONR ACO, and I don't think he had the information, although I think he asked his predecessor.

As far as asking Stanford, we did ask someone in the controller's office. I don't know the exact individual we asked, but I would have to assume it would be the controller or the assistant controller.

Now the other question you asked, did we have any trouble with asking for records? I'd say yes, we did. And I think we documented them back——

Mr. LENT. I think I have just one more question. I know my time is running low. You testified that Stanford, or actually Mr. Newton testified that Stanford denied your Agency supporting documentation for expenses for the Lake Tahoe retreat for the university board of trustees that amounted to $45,000.

Can you tell us to whom you directed your inquiry, and what exactly was the response?

Mr. LLOYD. We directed it to Ms. Fran Reed, who is part of the controller department, and she said we could have the record of the meeting. Unfortunately they don't keep records of meetings.

So then we asked for the agenda so we could see if anything related to organized research, and as yet, we haven't got that information. And that's been almost a month that we have been asking that.

Mr. DINGELL. Would the gentleman yield?

Mr. LENT. I would be happy to yield.

Mr. DINGELL. I'm curious; how can they claim that this then is an item which is properly included in the overhead accounts, if they have no documentation?

As I understand, there is a requirement that there be documentation that these kinds of events, if to be included in overhead accounts, must be accompanied by documentation to establish that they meet the criteria for such inclusions. Is that not so?

Mr. NEWTON. We would certainly expect to have that kind of documentation.

Mr. DINGELL. Beg your pardon?

Mr. NEWTON. We would certainly expect to have documentation that would support it before we would recommend acceptance of it.

Mr. DINGELL. Well, who was it that refused you this information?

Mr. NEWTON. Her name is Fran Reed.

Mr. DINGELL. Who is Fran Reed?

Mr. LLOYD. She is an assistant to the assistant controller.

Mr. DINGELL. And on what ground did Fran Reed refuse you this information?

Mr. LLOYD. That it was the—it was the same thing with GAO, but I can't think of the exact words; that it was proprietary.

Mr. DINGELL. It was what?

Mr. LLOYD. Proprietary.

Mr. DINGELL. If the gentleman would continue to yield here.

Let's talk about this retreat. Am I fair in inferring that there was a charge in excess of $45,000 which was submitted?

Mr. NEWTON. Yes.

Mr. DINGELL. That included lodging for 126 people, totaling in excess of $38,000; is that right?

Mr. NEWTON. Yes.

Mr. DINGELL. Is that correct?

Mr. LLOYD. Yes, that is correct.

Mr. DINGELL. And fountain charges covered approximately $1,500? Is that right?

Mr. LLOYD. That is correct, sir.

Mr. DINGELL. Social hour food, totaling in excess of $700?

Mr. LLOYD. Correct, sir.

Mr. DINGELL. I gather that there were various water skiing and pontoon boat rides that were included; is that right?

Mr. LLOYD. That is correct, sir, but they didn't charge for the skiing.

Mr. DINGELL. I beg your pardon?

Mr. LLOYD. They didn't charge for the skiing.

Mr. DINGELL. They did not charge for skiing.

Now there were 126 people. Are there 126 trustees?

Mr. LLOYD. As far as my knowledge, no.

Mr. NEWTON. No, there are not.

Mr. DINGELL. I understand there are 30?

Mr. LLOYD. 35.

Mr. NEWTON. It's in that range, is my understanding, too, sir.

Mr. DINGELL. And this information is proprietary?

Mr. LLOYD. Yes, sir.

Mr. DINGELL. Did you ask who went on this trip?

Mr. LLOYD. Yes, sir.

Mr. DINGELL. What did they tell you?

Mr. LLOYD. We got a record of most of the people, sir.

Mr. DINGELL. You got what?

Mr. LLOYD. We have a record of most of the people there, and we are checking them out now.

Mr. DINGELL. Well, what did you do to get that record?

Mr. LLOYD. Pardon?

Mr. DINGELL. What did you do to get that record?

Mr. LLOYD. Well, we got the voucher, and then we got the support for the voucher.

Mr. DINGELL. Now you have said, Mr. Newton, in connection with your full statement that they were not forthcoming and cooperative in presenting you with information and documents upon request. Is that correct?

Mr. NEWTON. Yes, sir, that is correct.

Mr. DINGELL. I will pursue this further, and I thank my good friend, Mr. Lent, for his courtesy.

Mr. LENT. I thank you, Mr. Chairman. I am happy to do it. Any time you ask for time, I will always give it to you.

Mr. Newton, you indicated a number of costs that you questioned in audits of 1984, 1985, and 1986, and these included computer systems used in fund-raising activities. I understand that fund-raising activity is one of the non-allowable expenses.

Mr. NEWTON. Yes, sir.

Mr. LENT. And also parking lot expenses.

Has Stanford responded to your questions on the fund-raising computer activities and the parking lot expenses?

Mr. NEWTON. Yes, they have. They have asserted that, for example, with the fund-raising activity, that the data base of alumni is maintained for some other purpose, other than fund-raising. In the experience that I have had with several alumni groups that I am associated with, I haven't seen anything but fund raising come out of those data base applications.

Mr. LENT. So you are not satisfied with the results that you have received, or the answers that you have received?

Mr. NEWTON. Absolutely not.

Mr. LENT. One more question. You recommended a 1991 billing rate of 52 percent. Now that is substantially lower than the billing rate utilized in prior years; correct?

Mr. NEWTON. Yes, it is.

Mr. LENT. How much money would the government save with the rate—and this is approximate—with the rate that you proposed as compared to the rate requested by Stanford?

Mr. NEWTON. According to our calculations, for which there are many pools, so please take this as an approximation, about $28 million.

Mr. LENT. You said $28 million?

Mr. NEWTON. Yes, sir.

Mr. LENT. In your opinion, when will the books be closed on the years in question? Specifically, 1981 to the present? And do you have any idea, again a ballpark idea, as to how much money may be owed to the Government?

Mr. NEWTON. It is very difficult to make an assessment for all of the years, particularly those years which we haven't even been given the opportunity to begin audits, which are again 1981 and 1982. But if I had to render an estimate, a somewhat speculative estimate, based on our analysis for the 1991 pricing proposal—which let me insert here that that proposal is based upon 1988 costs, with various escalation factors to what they would expect to have occur, to come out to 1991. Using that data base, it would appear that there may be some $15–$18 million per year for allocation issues. That is what we would associate with what we consider to be inappropriate allocations under the MOU's. That does not include the expressly unallowable type of issues that we have otherwise asserted.

Now when I have indicated before that we have about $5 million per year questioned, some of that—in fact, the major part of that—is where we have taken exception to certain data inputs in the MOU allocations. We did not audit those years using the default procedures of Circular A-21. We followed the MOU allocation procedures, because it was our understanding at the time that these were contractual documents which we could not do anything about. We audited to the MOU procedure.

So what we took exception to in arriving at the approximately $5 million was about $3.5 million associated with data inputs. That would not be on top of my estimate of the $15–$18 million. It would be an integral part of that.

Mr. LENT. Well, when you say $15–$18 million a year, and you are looking back now, as I understand it, to 1981?

Mr. NEWTON. We are looking back to primarily from 1983 forward. And let me explain why. There were some allocation procedures under MOU's before 1983, but the most significant ones came into place with the year 1983. The rate that Stanford was using jumped 11 points that year, when they instituted the variety of significant allocation procedures that they were proposing, and received approval for.

Mr. **Lent**. Just one final question, because we are talking about the $200 million figure, a $5 million a year figure, and now the $15–$18 million a year figure. I assume from what you are telling me that you are now coming down somewhere in the $15–$18 million a year figure, and we are going back to 1983, so that's 9 years, roughly, and we would be pretty close to the $200 million figure; somewhere between $135 and——

Mr. **Newton**. When you consider the allowability, the expressly allowability issues on top of it, it is not far from that figure.

Mr. **Lent**. I thank the gentleman.

Thank you, Mr. Chairman.

Mr. **Dingell**. Just to assist the Chair—we're trying to get a hand hold on the amount—if you take the fact that you're talking $15 to $18 million in improperly allocated expenses, and you multiply that by 10 years, you've got somewhere between $150 and $180 million. Is that right?

Mr. **Newton**. Yes, sir.

Mr. **Dingell**. Is that unreasonable?

Mr. **Newton**. For a 10-year period, I would say that's reasonable, but I have to put in a caveat about the years before 1983. The significant provisions that we are wrestling with now under the MOU's did not affect those years.

Mr. **Dingell**. OK. Now, you have another item of about $5 million here, you've indicated, in unallowable costs, liquor and things of that sort, is that right?

Mr. **Newton**. The total is $5 million. Included in that is—between $3.5 to $4 million of that, in fact, is exceptions which we have taken to data elements of the allocation which is made under the MOU. So if I insert the $15 to $18 million, if I go back, throw out the MOU, recalculate using the procedures of Circular A-21, then the total exception there would be the $15 to $18 million, plus another $1 or $2 million of unallowable costs.

Mr. **Dingell**. That's a year.

Mr. **Newton**. Yes, sir.

Mr. **Dingell**. So then that's another—so you're talking somewhere between $17 and $20 million a year?

Mr. **Newton**. The best estimate I could make on the basis of data that's presently available, I would say that's a reasonable approach, yes.

Mr. **Dingell**. Now, the actions that are taken, have been taken for fiscal year 1991, would indicate a loss of about $30 million to Stanford.

Mr. **Newton**. That's correct.

Mr. **Dingell**. Is that right?

Mr. **Newton**. Yes, sir.

Mr. **Dingell**. So if we take that $30 million item, this means that somewhere between $150 and $200, perhaps as high as, if you go on a flat multiplication of $30 million a year, somewhere between $150 to $300 million in the past decade that they got us for. Is that right?

Mr. **Newton**. The problem that I have with making a flat-out allocation like that is that a number of the items that we have in the

$30 million are items which we're not very certain about their being recurrent throughout that period. That's something we have to determine.

Mr. Dingell. I'm just doing a rough calculation here, trying to figure out how much is at stake. Now, this is money, then, that's loss to the taxpayers, isn't it?

Mr. Newton. Yes, sir.

Mr. Dingell. It also is money that's taken away from the research pool, is it not?

Mr. Newton. Yes, sir.

Mr. Dingell. If you figure you've got a research pool of X billion dollars, and you pull $150 to $300 million out of it over that period of time, you've lost somewhere between $150 and $300 million worth of research money. Have you not, during that period of time?

Mr. Newton. Yes, sir. If you're going to spend it for yachts or laundry, it's not going to go in research.

Mr. Dingell. That's right. It's gone to overhead and things of that kind that here are subject to serious challenge.

Mr. Newton. That's correct.

Mr. Dingell. The questions that you have been getting so far are not hostile to research, are they? They are hostile to taking money improperly from research programs. Isn't that right?

Mr. Newton. That's correct.

Mr. Dingell. Thank you.

The Chair is going to recognize now the distinguished gentleman from Ohio, Mr. Eckart.

Mr. Eckart. I thank the chairman very much.

Mr. Newton, I have a copy of the U.S. Code, and what prompted me to go get a copy of it were two comments that you made which I made note of, one entitled "no access" and the other one entitled "not cooperative."

For the record, let me read a section, a new section, of the Code: "Whoever, with intent to deceive or defraud the United States, endeavors to influence, obstruct or impede a Federal auditor in the performance of their official duties relating to a person receiving in excess of $100,000 directly or indirectly from the United States in any one year under a contract or subcontract, shall be fined under this title or imprisoned not more than 5 years or both." And then it goes on to define a person of the Federal auditor.

It's a crime to obstruct an audit, is it not, Mr. Newton?

Mr. Newton. That's what the law says. We have talked to our counsel about that particular law, and our counsel has advised us to be very careful about the application of the provision which you've just read because of the—he says there are very distinctive characteristics related to the intent of the person committing the act that must be carefully assessed before one asserts that provision.

So, as a result, we have issued guidance to our auditors that wherever they believe that an obstruction exists, that they should ask our counsel to come out and examine the specifics of that particular case.

Mr. Eckart. Mr. Newton, I used to also be a county prosecutor, and I'm fully aware of the necessity of intent, the applications of the words "knowing" or "willful." Those, indeed, are key elements of commissions of crime.

I must nonetheless assert to you my distress over what has been characterized as extensive delays and uncooperative stance, particularly as it relates to the receipt of requests for information by you and your Agency.

Without making any judgment as to the fact patterns in this particular matter, let me just assert to the public at large that at least this gentleman understands those provisions, particularly as they relate to those who have received Federal funds, to require cooperation of legitimate inspection of records relevant to public funds. While I will not assert that this provision is particularly applicable here, let me tell you that the intent of that certainly should be applicable.

Mr. Newton, one point I want to make is that the charges you have examined for 1987 and 1988 were certified by Stanford under criminal penalty as not having any unallowable charges in them. Your review demonstrates that, in fact, those unallowable charges were there, despite that certification.

What is your understanding of the penalty for making false certifications to the Government, and what has the DCAA done about the particularities of this finding?

Mr. NEWTON. I'll just say my understanding is that there are very stringent penalties for falsifications, but I'd have to jump over that a bit to the understanding I have of the certification itself. I have a copy of the certification in front of me that was signed for——

Mr. ECKART. And who was it certified by?

Mr. NEWTON. It's signed by a Franklin G. Riddle, Controller, signed August 10, 1990. This is for the fiscal year 1987 costs.

This certificate has provisions like "To the best of my knowledge and belief" leading into the thing. This has been somewhat liberally explored by people in the defense industry, not just Stanford University, and it's something, as I understand from counsel, that would have to be overcome. Where there's a mistake—this gives them a loophole in the event that they have made a mistake about it. So that's something that we have to deal with.

Where we see something that we think is patently unallowable, expressly unallowable, where one could not sign such a certificate in the environment without having knowledge of it, and having knowledge about it being expressly unallowable, we have procedures very well established for making referral for investigation in that circumstance.

Mr. ECKART. And as the controller, Mr. Newton, that person is responsible for having in place systems to catch these kinds of unallowable or unallocable requests, should that person not?

Mr. NEWTON. I certainly would expect it, yes, sir.

Mr. ECKART. And if the person responsible for catching things does not catch them, do they assume some culpability in the misfeasance, malfeasance or non-feasance in the performance of their duties?

Mr. NEWTON. Well, we're really treading in a legal area, and, again, I'm not a lawyer——

Mr. **Eckart**. Let me withdraw my question and ask you to characterize for me, then, the accounting and internal control systems at Stanford.

Mr. **Newton**. Inadequate.

Mr. **Eckart**. If those systems are inadequate and the person responsible for those systems, is that person then capable of signing a certification in a matter consistent with what that certification asserts to the Government?

Mr. **Newton**. If I were the controller, I could not sign it.

Mr. **Eckart**. DCAA has done audits in 1983, 1984, 1985 and 1986. What have you found regarding overcharges in those particular years?

Mr. **Newton**. I'm sorry. What were the years again, sir?

Mr. **Eckart**. 1983 through 1986.

Mr. **Newton**. I am going to ask Mr. Lloyd to give you the details. We have cited examples in the statement, but for more details on the specific audits, would you answer, please?

Mr. **Lloyd**. I think you did answer it, though, Fred. We said it is $5 million a year that was mostly allowable, but we are going to revisit it.

Mr. **Eckart**. Why do you feel compelled to revisit it?

Mr. **Lloyd**. Because of all the things we are finding on the review of transaction, testing, and internal controls for 1987 and 1988.

Mr. **Newton**. This is a point. We would like to be able to revisit it for all the allocation procedures, as well as the expressly unallowable items that Mr. Lloyd is mentioning. Those we will look at as long as the thing is open. Until they get it negotiated, we are going to consider it fair game for supplemental reports, but we have to have resolved somewhere the legal issue of whether our hands are tied on recovering the taxpayers' money on those years where the MOU's exist. We have asked ONR to provide us input on that, and we have not received it.

Mr. **Eckart**. I understood that point in the earlier line of questioning, and I think it is important to underscore that. There is still more for you all to chew over, as I understand.

Mr. Newton, one final question from my perspective. Stanford has originally proposed an overhead rate for 80 percent or so of this year. Your original assessment was that it should be somewhere around the low 50's.

What is DCAA's current position on what Stanford's overhead rate should be for this year?

Mr. **Newton**. We believe that 52 percent is the rate that should be established for the provisional billing rates for this particular year.

Now, I would have to say that in the details of that, there are a number of items which have been questioned in their entirety, because the contractor, Stanford University, will not provide us any supporting data. So, we have had to put it out.

If they would come forward with the supporting data, as requested, and cooperate, it may be a little bit more than 52; maybe 53, I don't know. But, we have not received supporting data on many items.

Mr. **Eckart**. The last point I would wish to make, Mr. Chairman, is a document, DCAA document, dated March 8, "Report on Review of Proposed Overhead Rates for fiscal years 1991 and 1992," and it is obviously relevant to my last question and, I guess, ultimately, my first question. It refers, on page 4, to the requested information not yet provided by Stanford—budget variances, equipment records, listing of equipment, accounting for income analysis of O&M, things that you have already referred to.

Can you advise us as to the status of these important matters in dispute and Stanford's cooperative nature in resolving them?

Mr. **Newton**. I am going to ask Mr. Tueller to respond.

Mr. **Tueller**. These 12 items range in length of time requests are outstanding from anywhere from back in the timeframe of September of last year to within the last 2 or 3 weeks. The library study that is asked for on here is in the September timeframe.

The budget variance analysis is a little newer than that, but some of these things are the kinds of things that you would expect when you are provided a proposal for a rate to bill in a given year. These things should be readily available and provided at the same time the proposal is there.

Mr. **Eckart**. Thank you.

I am urged to go vote, otherwise I will miss that, and lest I be audited by you on my voting record, I am going to excuse myself.

Mr. **Wyden** [presiding]. Has the gentleman from Ohio completed his questioning?

Mr. **Eckart**. Yes.

Mr. **Wyden**. OK.

Gentlemen, one question I had—I know you all had been looking at some other universities, and I had been hearing unconfirmed reports that Cal Tech University had had a situation fairly similar to the Stanford experience with the trustees.

Now, let me ask you, Mr. Lloyd, is that, in fact, the case, and if it is, do you all have any information with respect to that institution as to whether or not they had a program with their trustees similar to the Stanford situation?

Mr. **Lloyd**. I cannot answer that, because I do not have Cal Tech under my cognizance.

Mr. **Newton**. I have a response to you, sir.

California Institute of Technology is the example that I include in my statement without a name, where they came forward with a $500,000 voluntary deletion. They did have an amount, approximately $80,000, for a retreat type of activity similar to that which we had seen at Stanford.

When some inquiries were being made of that, they immediately asked to be able to review that and a variety of other documents, and they came back to us for several issues, not just the retreat, but several issues that they decided to exclude 100 percent. Even where, from our own assessment, some of them had credibility as allowable expenses.

Mr. **Wyden**. So, Cal Tech gets first prize in terms of overbilling as far as trustees' retreats, I gather.

What were some of those other charges at Cal Tech that, when you queried them, they moved quickly to disallow?

Mr. Tueller. There were dues and subscriptions. There was some country club memberships in that and some entertainment expenses, as well as the retreat expenses that were in there. So, it really fell into those three categories.

Mr. Wyden. How much did it come to in the country club area?

Mr. Tueller. I would have to go back and get the specific document on that, and I do not have that with me right now.

Mr. Wyden. Let us have that, though, for the record, both in terms of the country club and the question of the entertainment expenses, as well, at Cal Tech.

[The information follows:]

California Institute of Technology expenses	1987	1988	1989	1990
Country club (golf club dues)	$1,567	None	$6,800	$3,558
Entertainment	16,811	$23,162	24,044	23,023

All of the above expenses were voluntarily deleted by the university from indirect cost claims to the Federal Government

Mr. Wyden. Mr. Newton, concerning Stanford, do you believe that they were simply incapable of putting in place a proper accounting system and the problem stemmed from incompetence, or do you believe this was a question, primarily, of intent and trying deliberately to cut corners?

Mr. Newton. I have too much respect for the institution and the available expertise that that university holds on accounting matters to believe that they do not have the competence somewhere in their organization to be able to put together a good system.

What reasons have led them to have inappropriate allocation methods I really do not know.

Mr. Wyden. Now, has Stanford actually withdrawn the charges for the president's house and the yacht?

Mr. Newton. No, sir.

Mr. Wyden. So, as of now, they have said they have withdrawn them.

My understanding is—and I think that at least they have told the press that they have withdrawn these charges. But your understanding is that, as of today, March 13, Stanford has not withdrawn the charges for the president's house and the yacht.

Mr. Newton. We keep looking for a credit on the billings.

We have examined the forecast for fiscal year 1991 forward pricing rates, which is based upon cost incurred in 1988, and to the best of our understanding, the amount that was projected includes the amount that was billed and charged to the Government at that time for the yacht Victoria.

Mr. Wyden. Well, this is an extremely important point, because I have gathered, both from the press accounts and elsewhere, that those charges were withdrawn, but it is very helpful to know that you have not found that they have been, and we are going to be asking that of the Stanford officials later this afternoon.

Now, are these charges for the president's house and the yacht in the 1991 negotiations, to the best of your knowledge?

Mr. Newton. I am unable to say what is in the 1991 negotiations, which is a rate, I understand, a negotiated rate of 70 percent. We have not received any breakdown. We were not invited to the negotiation conference, at which time that 70 percent was arrived at.

So, there is no way for the DCAA to be able to say one way or the other what is in the eight points that they did take off of the proposed rate.

Mr. **Wyden**. Do you believe you should have access to that information?

Mr. **Newton**. Absolutely.

Mr. **Wyden**. Why have they not made it available to you?

Mr. **Newton**. I do not know.

Mr. **Wyden**. All right.

You all have been very helpful, and we appreciate the cooperation. As you can tell, we have votes on the floor, and it is going to be a hectic day, but we thank you and appreciate your work.

Mr. **Newton**. Yes, sir. You are welcome.

Mr. **Wyden**. Panel 3, Rear Adm. William C. Miller, Chief of Naval Research, Office of Naval Research, U.S. Navy, Arlington; accompanied by Mr. Thomas J. Dolan, the Office of Naval Research; Mr. Robin A. Simpson, Office of Naval Research; and Mr. Paul L. Biddle of Stanford and the Office of Naval Research, if you all will come forward, we will have some certain formalities to take care of.

As I understand it, Admiral Miller, you will be making a formal presentation, but since all four of you may be responding to subcommittee questions, I think it would be appropriate to swear all four of you at this time. Do any of you have any objection to being sworn as a witness.

[Chorus of no's.]

[Witnesses sworn.]

Mr. **Wyden**. Gentlemen, let me also advise you of your right to have counsel with you throughout your appearance today. Do any of you desire to be represented by counsel in your appearances before the subcommittee?

[Chorus of no's.]

Mr. **Wyden**. All right. Let me also note your right to have a copy of the committee rules with you throughout your presentation before the subcommittee. I note for the record that the rules are available. Admiral Miller, we will make your prepared remarks a part of the record in their entirety, and if, in the interest of time, you could summarize your presentation, that would be very helpful. Welcome.

TESTIMONY OF REAR ADM. WILLIAM C. MILLER, CHIEF, NAVAL RESEARCH, OFFICE OF NAVAL RESEARCH, U.S. NAVY, ACCOMPANIED BY THOMAS J. DOLAN, JR., DIRECTOR, UNIVERSITY BUSINESS AFFAIRS; ROBIN A SIMPSON, DIRECTOR, MONTEREY DETACHMENT; AND PAUL L. BIDDLE, RESIDENT REPRESENTATIVE, STANFORD UNIVERSITY

Admiral **Miller**. Thank you, Mr. Chairman. I appreciate this opportunity to testify before this committee regarding the administration of federally sponsored research at the Nation's colleges and universities. For the record, sir, I am the Chief of Naval Research, and as such, I am responsible for planning and execution of the Navy's investments in science and technology.

My immediate superior in the Navy organization is the Navy's Acquisition Executive, Mr. Gerald A. Cann, the Assistant Secretary of the Navy for Research, Development and Acquisition. Subordinate to me are three headquarters organizations, including the Office of Naval Research, and the Navy's Corporate Research Laboratories.

Many of the issues discussed here today relate to the performance of the Office of Naval Research with respect to its duties in negotiating indirect costs, sometimes called overhead costs, at the 39 colleges and universities across the country for which the Department of Defense has been assigned cognizance.

I assumed my duties as Chief of Naval Research in June 1990, just as the extent of the problem at Stanford was becoming apparent here in Washington. In my subsequent review of the situation, it appears that symptoms of the problem had been observed as much as 3 years earlier, and some actions initiated to define and rectify those problems.

When I first became aware of the problem in July 1990, I had three priorities; (1) to determine the nature and the magnitude of the problem; (2) to apply sufficient resources to the problem to contain it, to resolve it and to protect the interests of the Government; and (3) to take whatever personnel action proved appropriate when the question of personnel accountability had been resolved.

The problem we found relates directly to the business approach employed by ONR, acting for the Department of Defense, and the university community. Under this business approach, indirect costs or overhead rates at a particular university are set for a forthcoming fiscal year through negotiations between the onsite Administrative Contracting Officer and the university.

These negotiations are based upon the best estimates of both the university costs and the business base of the university over that forthcoming year. This rate then becomes the basis for University billing its Government customers over the next fiscal year.

After the year is completed, the Government is supposed to come back and audit the actual expenditures of the university and to adjust the rate and balance the books, regarding any over or under-allocation and collection by the university. The problem at Stanford had three principle parts.

First, ONR had entered into a number of advance agreements referred to frequently as Memoranda of Understanding, or MOU's, without proper review or approval. Now, subsequent review has caused us to doubt that these agreements comply with Federal regulations or that they result in equitable allocation of costs to the Government.

Second, the local Administrative Contracting Officer was not receiving audit and legal review of the university's indirect cost proposals before negotiating billing rates for the forthcoming year. So, he had been inadequately prepared to represent the Government's interests in these negotiations. Consequently, we have serious concerns about the accuracy of the negotiated estimates of allowable University costs and, therefore, the validity of the payments already made to Stanford in support of Government research.

Third, audits had not been conducted of the actual costs incurred by the university since 1981. So, we have a substantial backlog of business to work off on this particular campus. This problem was further aggravated by rising indirect costs resulting from an aggressive building program at Stanford during this period and Stanford's own lack of adequate internal controls over their cost accounting system.

In response to this problem, I have established a team of very senior and experienced business managers to represent the Government's interests at the bargaining table until this matter is resolved. We are also working very closely with DCAA and other Government agencies to review and dispose of our concerns with regard to the numerous Memoranda of Understanding in place; and we have been supported by very substantial DCAA resources testified to earlier this morning; and we are working to bring the business of Government current at this University.

My statement for the record provides additional details regarding the specific actions I have taken, as well as actions I have directed with the Office of Naval Research to markedly tighten up their business operations. In summary, Mr. Chairman, we have initiated action to establish at Stanford an effective, productive armslength business relationship with the Government.

At the same time, we have also initiated action to bring the same standards of rigor and peer review to the Office of Naval Research business operations that have been the hallmark of ONR-supported science since Congress established the Office of Naval Research in 1946. Thank you, Mr. Chairman. This concludes my opening remarks.

I might add for the benefit of the committee that the incumbents in the chain of command between ONR headquarters and Stanford University are here with me at the table today. Mr. Dolan is the Director of ONR University Business Affairs. Mr. Robin Simpson is the Western Regional Manager of ONR Business Affairs, and Mr. Paul Biddle is the ONR Resident Representative or Administrative Contracting Officer on campus at Stanford University. Thank you, sir.

[The prepared statement of Rear Admiral Miller follows:]

REAR ADMIRAL WILLIAM C. MILLER

CHIEF OF NAVAL RESEARCH

TESTIMONY BEFORE

UNITED STATES HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

COMMITTEE ON ENERGY AND COMMERCE

MARCH 13, 1991

Mr. Chairman and members of the Committee, I appreciate this opportunity to testify before this Committee on contract administration of federally sponsored research at colleges and universities.

My testimony today will focus on contract administration and indirect cost rates at Stanford University. I will provide you with the findings of fact on reports from our Navy contract administrator on the Stanford campus that indirect cost rate negotiations for government-sponsored research may have resulted in significant overpayments to the University.

On August 23, 1990, I initiated an administrative inquiry to review issues relating to Office of Naval Research (ONR) contract administration at Stanford University. In particular, I asked my Inspector General (IG) to review the evidence supporting possible overcharges by Stanford, as well as reports of partiality to Stanford by ONR's contract administration organization.

Mr. Chairman, at this point, I would like to submit to the Committee a copy of the IG report and request that it be entered into the hearing record.

I have carefully reviewed the report, and fully concur in its findings. Because the report itself is a lengthy, detailed review of our indirect cost rate negotiation at Stanford during the period 1980 to 1990, I will summarize its findings:

Inspector General Findings of Fact

Issue: What factual basis does the ONR Resident Representative at Stanford have to support his belief that the overhead rate for Stanford University has been overpaid by as much as $200 million during the past ten years?

Finding: The IG review was not able to factually support the Resident Representative's contention of a $200 million overpayment to Stanford. The ONR Resident Representative's estimate was based upon assumptions and professional judgements that he considered reasonable, but which were factually unsupportable.

Issue: Is there any factual data available to support a contention of any overpayment?

Finding: The IG review found that there is a possibility that Stanford has provisionally recovered costs which final audits may determine to be either unallowable or inappropriate for allocation as costs to government-sponsored research. Audit reviews for many of the years during the period 1981 to 1989 were either not requested or not provided. As a result, historic audits of actually incurred costs and subsequent negotiations of final rates for many of those years are still pending. Overhead rates during any given year are not considered final until costs have been audited, and negotiations completed, regarding the allowability of charges. Until these procedures have been completed, the possibility remains that some of the overhead costs provisionally recovered by Stanford should not have been charged to the government. However, specific amounts cannot be factually substantiated, or accurately estimated, pending detailed legal and audit reviews.

Issue: What evidence exists that government personnel are not being impartial in their dealings with Stanford University?

Finding: The IG report identified certain facts and situations that could have been perceived as indicating partiality on the part of the ONR University Business Affairs staff or other Navy personnel in their dealings with Stanford. However, a closer examination of these facts did not support the conclusion that there was any substance to such perceptions.

Mr. Chairman, please note that the scope of this IG report, as commissioned in August 1990, was to establish any factual evidence of overpayment, or bias on the part of government administrators. The inquiry reviewed the practices and procedures of the Office of Naval Research in setting indirect cost rates at Stanford in the context of these three specific questions. The report did not address Stanford's accounting practices or internal controls, or examine vouchers submitted by Stanford over the years. Reviews and recommendations regarding these functions, under DoD procedures, are being addressed through advisory audit reports provided by the Defense Contract Audit Agency (DCAA).

While the IG report did not substantiate perceptions of bias toward Stanford by government administrators, and could not quantify any potential overpayment to Stanford until audits have been completed by the Defense Contract Audit Agency, the IG report did conclude that the potential for overpayments does exist, and raised questions regarding Stanford's FY 1980 to FY 1989 indirect cost rates as negotiated by the Office of Naval Research.

A natural question arising from these findings is, "how could this happen?" The answer is, that existing management controls (audits, reviews and formal approval of indirect cost rate negotiations), if properly implemented, should have prevented, or identified and corrected, many of the management weaknesses identified in the report. Nevertheless, the report documents that implementation of these management controls was inadequate.

Requirements for action are thus twofold: First, to address and rectify the identified contracting problems; and second, to establish individual accountability for those problems. Action to satisfy the first of these requirements was initiated in December 1990 by the establishment of a Special University Team, which I will discuss shortly. The second requirement -- that of establishing individual accountability -- is now under review by a fact finding panel, headed by a senior Naval officer who reports directly to me. I will advise the Committee of the results and action taken upon completion of that review next month.

It was clear, even before the IG report was completed, that several contract administration and business issues needed to be resolved relating to Stanford's indirect cost rates. Toward this end, on 13 December 1990, I established a Special University Team composed of senior personnel from my headquarters and a Washington D.C., field activity. The Team was directed to review the current provisional indirect cost rate at Stanford, as well as DCAA audit findings, and to begin work on negotiating provisional indirect cost rates for FY 1991 and final indirect cost rates at Stanford for the past ten years. In this effort, I directed the Team to work closely with DCAA auditors and Department of Health and Human Services (DHHS) field personnel. DCAA is currently conducting historical audits of Stanford's actual costs for FY 1987 and FY 1988, and has completed historical audits for FY 1983 to FY 1986. Audit findings may result in a subsequent revision to the allowance of some costs for which the government has reimbursed Stanford for work accomplished during those years.

DCAA will commence audits for FY 1981 through FY 1982 as soon as its work is completed on the later years. DCAA auditors are also assisting resolution of this issue by conducting a number of special audits and reviews, including a review of the University's internal controls and a review of the Navy-Stanford agreements concerning costs charged to research contracts. These latter agreements, known as Memoranda of Understanding (MoUs), require both legal and audit reviews in order for the Special University Team to determine the validity of agreements recorded therein regarding cost allocations to government contracts. Auditors from DCAA's San Francisco Regional Office will keep the Special University Team apprised of significant findings from these audits and reviews.

The Special University Team, under the terms of its charter, has already addressed many of the specific recommendations contained in the IG report related to business relations with Stanford. It has:

1. Negotiated an Interim Agreement with Stanford University on 20 December 1990 that established procedures for review of all Stanford MoUs.

2. Established a procedure for determining final rates for past years, as part of the Interim Agreement. The Team will address and resolve audit issues as part of this process.

3. Negotiated a revised provisional (billing) rate of 70 percent. Stanford proposed a FY 1991 rate of 78 percent which they later revised to 76 percent. The Special Team reduced this rate to reflect unresolved charges questioned by audits. This will protect the government's interest if the final negotiated fixed rate does not allow these charges. In negotiating Stanford's FY 1991 indirect cost rates, the Team will ensure that adequate cost analyses, and legal reviews have been obtained to justify both the calculation methodology and the actual rate paid to Stanford for this year. In addition, the Interim Agreement provides for later revision of the FY 1991 rates if required after completion of the MoU review.

The following additional actions have also been initiated to address deficiencies and implement corrective measures identified in the IG report's recommendations:

The Special University Team is currently reviewing all MoUs between the Navy and Stanford. Concurrent with this review, the Special Team received--in mid-February, 1991--written recommendations from the Western Regional Director of the Department of Health and Human Services (DHHS) and the Western Region Branch Manager of the Defense Contract Audit Agency (DCAA) that the MoUs be cancelled.

These specific advisory recommendations of DHHS and DCAA Branch Managers represent important supporting documentation, and will assist the Special Team in making a final determination. The Team is pursuing an agressive schedule for reviewing the MoUs and expects to complete their review by mid-April, 1991.

In addition, the Director of the Office of Naval Research (ONR) has completed a task I assigned him -- to prepare for his staff of administrative contracting officers in the field -- a comprehensive practices and procedures manual which would be fully compliant with applicable sections of Federal Acquisition Regulations, the DoD Supplement to these Regulations, and Navy Acquisition Procedures. I am now reviewing this manual and expect to approve it for use by field contract administrators by 1 April 1991. This should ensure stringent business procedures governing contract administration, as well as uniform and consistent cost treatment at all universities under DoD cognizance. I have also requested the Director, ONR, to report to me by 1 May 1991, and every 6 months thereafter, regarding the effectiveness of those procedures in ensuring uniform cost treatment.

Again, with the Committee's permission, I would like to submit for inclusion in the record, copies of my letters to the University Team Chairman and to the Director, Office of Naval Research, outlining corrective measures they are to complete to resolve current issues and ensure sound business practices for the future. Specific corrective measures include:

Indirect Cost Rates

1. Formal approval by Navy University Business Affairs Office management will be obtained in negotiating indirect cost rates.
2. Adequate supporting documentation will be obtained (including advisory audit reports and legal opinions) for all business clearances; and, when appropriate, coordination with other government agencies and departments will be accomplished.
3. Audit and legal input will be obtained prior to the finalization of actual indirect cost rates for all universities under DoD cognizance.
4. Every effort will be made, supported by timely audits, to ensure that final indirect cost rates for all universities under DoD cognizance are negotiated within two years of the close of the university's fiscal year.

Memoranda of Understanding (MoUs)

1. All existing MoUs between the Office of Naval Research and any of its cognizant universities will be reviewed by Navy legal staff.

2. All MoUs which are advanced agreements as to costs will be submitted to the Office of the Assistant Secretary of the Navy via the ONR University Business Affairs Directorate for formal pre- and post-negotiation business clearance review.

3. An expiration date will be included in each MoU administered by the Office of Naval Research.

4. Formal DCAA audit reports will be submitted as supporting documentation for each MoU administered by the Office of Naval Research.

5. Coordination with other government agencies and departments having significant business interests at the university will be mandated.

6. Review of special (cost analysis) studies supporting MoUs will be conducted every two years as required by Office of Management and Budget (OMB) Circular A-21.

7. ONR Resident Representatives will ensure universities conduct physical inventories every two years to support use allowances/depreciation, as required by OMB Circular A-21.

8. Negotiation of all MoUs will be completed prior to incurring the costs involved, when feasible.

9. Strict adherence to the principles and procedures of the Federal Acquisition Regulation 31.109 (Advance Agreements) will be emphasized when entering into MoUs.

The Director, ONR, is also performing a study of the MoUs at universities, other than Stanford, which are under DoD cognizance. At a minimum, that study will include:

1. Determination of which MoUs are currently active and legally binding.

2. Audits of all active MoUs with these universities.

3. Negotiation of revisions to each active MoU to resolve any issues raised by these audits and sustained during negotiation.

4. Negotiation of an expiration date for each active MoU.

Navy officials, in the course of this effort, will require the requisite supporting studies and analyses in support of MoUs requiring these data, and will select an appropriate cost model and study methodology after consultation with DCAA, DHHS, and the university concerned.

The Navy Special University Team, supported by the Defense Contract Audit Agency and representatives of the Department of Health and Human Services, is bringing Stanford's indirect cost reimbursement rate negotiations current. Future rate negotiations will be supported by all necessary audits to ensure the highest standard of public accountability of federally sponsored research at universities is maintained.

The Committee should be assured that I will keep the Committee informed of the results of ongoing audits, legal analyses, rate negotiations, and related issues.

Mr. Chairman, it is clear that one of the most important factors adversely affecting indirect cost negotiations at Stanford has been the lack of timely and adequate cost audits. The business problems at Stanford have highlighted the need for a closer and more effective relationship between Office of Naval Research field representatives and the regional field offices of the Defense Contract Audit Agency. The Navy and DCAA are now working closely together on Stanford indirect cost issues. The Director, DCAA, and I have discussed this matter and anticipate a strengthened relationship between our two agencies in the future.

One initiative that may help alleviate the problems inherent in conducting business negotiations without adequate audit support is the single audit concept, utilizing the combined resources of federal, state, and university auditors. This initiative shows promise of greater efficiency, lower demands upon federal manpower, and increased timeliness. Proceeding under the title of University Coordinated Audit Program, or UCAP, the program was initiated in 1989 by the Office of Naval Research. Under this program, duplicate and multiple audits are avoided by coordinating required federal, state, and university audits and allowing each audit group to rely on the work of the other under established accounting principles.

With the inception of this program, the backlog of audits at the two UCAP demonstration institutions--Massachusetts Institute of Technology and Pennsylvania State University--has been eliminated. Expansion of the UCAP initiative in November, 1990 has resulted in substantial progress being made in planning for reducing the backlog of audits at twelve other institutions.

Additionally, because the situation at Stanford raised questions regarding protection of the government's interest at other universities, DCAA has conducted a risk analysis at DoD cognizant universities, and their auditors are working with ONR administrative contracting officers to review areas of potential risk at other Universities. I expect that thorough audits will find questioned costs at other Universities, but I have no evidence at this time that other schools are likely to offer a high risk of incurring significant questioned costs like those discovered at Stanford.

In summary, the recently completed IG report identified management weaknesses in indirect cost rate negotiation procedures. We are taking steps to correct those deficiencies and to assess personal accountability where appropriate. I am determined that these positive steps to correct deficiencies in government contract administration, together with the strengthened business clearance and audit procedures instituted, will improve administration at all universities under DoD cognizance.

Mr. Chairman, I believe that existing law and federal regulation, supported by timely audits, do provide the requisite mechanisms to identify, control, and ensure proper accountability for federal research funds at universities. The situation at Stanford resulted from inadequate implementation of these regulations and from an absence of timely and thorough audits and legal analyses. I can assure the Committee that both Navy senior management and senior management at DCAA have taken substantial steps to strengthen our implementation of these business procedures and to ensure that the taxpayers' interests are fully represented at the negotiation table.

Lastly, Mr. Chairman, while we work through these problems, it is important that we recall that the leading edge of the Nation's basic scientific research is pursued by professors and graduate students at colleges and universities across the country. Maintaining an effective, productive relationship between federal research sponsors and the Nation's universities is vital to continued U.S. economic and military competitiveness. For these reasons, the national interest demands two things of us, to maintain this mutually beneficial partnership: the Federal Government must pay its full share of allowable costs incurred by universities in support of government research; but also, the scarce research dollars available must be spent wisely and accounted for with the diligence that the taxpayers deserve.

-end-

Mr. **Wyden**. Admiral, do any of your associates desire to make an opening presentation? Gentlemen?

[Chorus of no's.]

Mr. **Wyden**. Admiral Miller, on Monday you told the subcommittee staff that, in your view, the taxpayers did not get their money's worth at Stanford during the 1980's. What did you mean by that?

Admiral **Miller**. By that, sir, I was referring to our considerable doubt that the billing rates used to support contract research during the decade of the 1980's were accurate. There was considerable doubt that the MOU's in place actually comply with Federal regulations. We have doubt that adequate justification was provided for them, and we believe that it is likely the Government was overbilled for research performed at Stanford during that decade.

Mr. **Wyden**. Who at the university do you hold responsible for the kind of problems that you found?

Admiral **Miller**. Sir, from my command experience, I am held responsible for my command in the Navy and, in that regard, I would believe that the President of Stanford University is responsible for the entire operations of that University.

Mr. **Wyden**. Admiral, you went on to say that you wouldn't stand behind the Navy's oversight and actions during the 1980's. Would you tell the subcommittee what you believe the Navy did wrong with respect to its oversight of Stanford during the 1980's?

Admiral **Miller**. Yes, sir. I don't recall using the exact words you cited, but the intent is certainly correct; that when I first became aware of this problem last Summer, I initiated an Inspector General investigation in order to better define the problem. That report defined a number of areas in which we had been conducting business at Stanford, without adequate audit support or legal reviews of Memoranda of Understanding before we entered into those agreements. Also, we had not aggressively sought audits of the indirect cost proposals of the university before we set the provisional billing rates for the forthcoming year. Neither had we aggressively sought audits of the actual costs incurred by the university over this period, so that any over-collection by the university could be adjusted.

I have submitted, sir, a copy of those findings contained in the Inspector General's Report. That report is very detailed in its compilation of the failings of ONR oversight at Stanford.

Mr. **Wyden**. Admiral, Stanford and the officials, Dr. Kennedy and others, have stated that your Inspector General's Report exonerated them. Do you agree with that characterization of the Inspector General's Report and if not, how would you describe the Inspector General's findings?

Admiral **Miller**. I don't know of anyone in Government who would agree with that characterization of the IG findings, sir. In fact, when I look at the degree of inspections and auditing going on at Stanford and the substantial resources the Government has placed on that campus to resolve this problem, I can only say that a private citizen with no other information on this problem could clearly conclude that the Government considered this a very serious problem and we are putting serious resources on it.

Mr. **Wyden**. Admiral, a number of the special agreements, these Memorandums of Understanding that the university has signed with the Navy are based on special studies that have been performed by Stanford. Now, these are required by this OMB Circular A-21 to be reliable and statistically sound.

Is that the case at Stanford? Were those studies actually done?

Admiral **Miller**. There were four MOU's in which the basis for the MOU was a special study in the context of OMB Circular A-21. Those four are the Library costs, Student Services, Utilities, and Departmental Administration. In every case, we have concluded and have informed the university that we do not consider the special studies, as they exist today, to be adequate bases for our continuing business relationship and, in fact, we have scheduled, within the next 2 weeks, meetings with Stanford during which they are to respond to our expressions of concern.

Mr. **Wyden**. So, are you saying that there aren't any valid studies to support what amounts to possibly $20 million in charges?

Admiral **Miller**. I do not believe that the four special studies that I cited would equate to a $20 million difference. I have no information to validate that, but, based on the information we have now, the special studies performed earlier are considered inadequate.

Mr. **Wyden**. Now, there was a study from 1979 requiring a 20 percent reduction on subsistence charges to cover unallowables. Was that proven to be statistically sound?

Admiral **Miller**. I have no information that a special study on that was performed, sir.

Mr. **Wyden**. The Office of Naval Research was required to perform audits and legal analyses of these Memorandums of Understanding. Were these audits and legal analyses done?

Admiral **Miller**. The Office of Naval Research should have requested that DCAA conduct the audits. We do not have audit staff. DCAA shares this responsibility for the Department of Defense with us. The audits, in fact, were not completed.

Mr. **Wyden**. Did you all request DCAA to do these audits?

Admiral **Miller**. On MOU's? On the rates?

Mr. **Wyden**. Right.

Admiral **Miller**. On the MOU's, I know of no request for DCAA to conduct audits.

Mr. **Wyden**. Should that have been done if that was required?

Admiral **Miller**. Yes, sir, that should.

Mr. **Wyden**. Why wasn't it done? It was just an oversight?

Admiral **Miller**. I know of no reason why that should not have been done.

Mr. **Wyden**. All right. I see our chairman is back. Does the lack of these reviews that we're discussing make the Government vulnerable to overcharging? It seems to me that these kinds of reviews are at least a minimal level of protection for the taxpayer, and without them, you know, the Government is just a sitting duck for overcharges; is that right?

Admiral **Miller**. I fully concur with that statement, sir. I believe that for entering into an MOU—which is, in fact, an advance agreement in the context of the Federal Acquisition Regulations—adequate preparation for entering into that kind of negotiated agreement with the university would have included audits as well as legal reviews, neither of which was conducted.

Mr. **Wyden**. One other point, and then I want to recognize my colleague from New York.

Who was responsible, Admiral Miller, for not requesting these audits? Have you all been able to determine that?

Admiral **Miller**. Sir, I have commissioned a special personnel review panel to look into the question of personnel accountability. I am the Government official who is going to have to take whatever action is appropriate on that issue. I have not assigned a name nor accountability at this time. I expect to hear from that panel by the end of next month.

Mr. **Wyden**. All right. Let me recognize the gentleman from New York for his questions.

Mr. **Lent**. Thank you, Mr. Chairman.

Admiral Miller, after the ONR Inspector General released its report, Stanford's Office of the President released a statement dated February 7, 1991 that said the IG had found that the accusations made against Stanford were "baseless." Do you agree that that characterization of the IG report is accurate or inaccurate?

Admiral **Miller**. I would not agree with that characterization of the report, sir; but if you will allow me, I would like to point out that the Inspector General works for me, he does not work for the Office of Naval Research. The Chief of Naval Research is his next superior in the chain of command.

Mr. **Lent**. Well, didn't he—this subordinate of yours, didn't he find a very serious situation at Stanford?

Admiral **Miller**. Yes, sir. Very serious.

Mr. **Lent**. He couldn't quantify the particular figure of $200 million; but he nonetheless found that there was reason to believe that there had been a lot of misleading and misdirected accounting.

Admiral **Miller**. Yes, sir. That is correct. I believe you are referring to Mr. Biddle. The fact that he couldn't quantify it was not really important to me, because what was really pointed out was that we did have a serious problem. As we heard this morning, even the auditors would have difficulty quantifying the exact amount of the problem right now.

Mr. **Lent**. Mr. Biddle, you do not disagree with that? You did not, at any time, state that your $200 million figure was definitive, did you?

Mr. **Biddle**. It was meant to indicate a level of exposure.

Mr. **Lent**. Isn't it true that the very thing you complained of, the lack of audits, prevented you from being more definitive?

Mr. **Biddle**. I believe that was the contributing factor to the lack of finiteness, yes.

Mr. **Lent**. In fact, when all the audits are done, if we ever reach that point, and the final agreement is reached on allowable cost, it is possible, is it not, that the amount owed to the Government will be determined to be in excess of the $200 million figure?

Mr. **Biddle**. I think there is considerable likelihood of that. It must be remembered though, that once DCAA has an audit finding, it must be negotiated, and the indirect cost rate could fall back. If you are saying, would the questioned costs contained in DCAA audit reports approximate or exceed $200 million, I believe there is considerable likelihood of that.

Mr. **Lent**. Admiral, you stated in your testimony that you fully concur with the findings of the report of the Inspector General, is that correct?

Admiral **Miller**. That is correct.

Mr. **Lent**. I would like to ask you several questions about those findings. The first question posed was this: "What factual basis does the Resident Representative of Stanford, Mr. Biddle, have to support his belief that the overhead rate for Stanford University has been overpaid by as much as an estimated $200 million during the past 10 years?" That was at page 41.

Your team concluded: "The review of ONRRR—Stanford's explanations to support the contention of an estimated $200 million overpayment revealed that his methodologies, assumptions and computations were primarily judgmental and speculative in nature, rather than factual. Most of the data used by ONRRR Stanford—Mr. Biddle—was not verified or verifiable by supporting documentation and is not reconciled or reconcilable to accounting records." That is at page 45.

My question is how could Mr. Biddle use verifiable data when neither ONR or Stanford had conducted annual audits as required?

Admiral **Miller**. There were no audits conducted by DCAA. DCAA is to conduct those audits in support of Stanford's negotiations and other administrative contracting officer functions on the campus. The audit data was not available from DCAA. Therefore, neither Mr. Biddle, nor anybody else, has the basis for making an accurate estimate of what the total Government exposure at this University is for the period in question.

In fact, I listened to Mr. Newton this morning use many of the same words, including "speculative," when he caveated his own estimation of the estimate this morning.

Mr. **Lent**. Well, you know, or maybe you do not, but in conversations with subcommittee staff your investigators admitted they had no idea whether the actual overpayment was larger or smaller than $200 million. Were you aware of that?

Admiral **Miller**. I was not aware of that; but I would subscribe to that. I do not think we know today the actual exposure to the Government.

Mr. **Lent**. The DCAA has already testified that their preliminary investigation of the effect of the MOU's between Stanford and ONR was that the MOU's may have cost the Government somewhere between $15 and $18 million a year.

Since we are talking about a 10-year period, doesn't this seem rather close to the $200 million dollar overpayment which Mr. Biddle alleged——

Admiral **Miller**. Mr. Newton, when he gave us that——

Mr. **Lent** [continuing]. Which Mr. Biddle estimated?

Admiral **Miller**. Mr. Newton, when he testified to the $15 to $18 million, said that estimate was based on the 1991 cost proposal from Stanford. I think it would be a stretch of judgment to just multiply that by 10 and come up with a figure for the 10 years.

I think that is especially true, in view of the fact that over the entire 10-year period, Stanford University, to the best of my recollection, collected a total of $600 million in overhead and no one yet has suggested that half of that or a third of that would fall into the range of what is now in question.

I have no data on which to make an accurate estimate, sir. I do not think anybody does.

Mr. **Lent**. You have just answered the question I was going to ask you, which is whether you really do not know? You really do not know.

Admiral **Miller**. I would have to use judgment and speculation to come up with a number, just like Mr. Biddle did.

Mr. **Lent**. Now, Mr. Biddle had alerted your office to what he termed a "cozy relationship" between ONR and Stanford. What do you think he meant by that?

Admiral **Miller**. I did not know what he meant by that because of the way it was expressed, in sort of a colloquial expression. So I asked the Inspector General and his team to talk to Mr. Biddle and find out what he meant by that.

It is my understanding, both from the report and from talking to the members of the IG team during the course of their investigation and subsequently, that Mr. Biddle's concern was expressed based upon a number of factors: the large numbers of MOU's in existence with Stanford University; that the final billing or the final rates were open for the entire 10-year period at Stanford; that we had not gone back and audited and closed out the books on each of those years; that his own office, he believed, had not been staffed adequately; that there had been inappropriate communication between Stanford University and ONR headquarters; and that there had been meddling between ONR headquarters and Mr. Biddle's efforts to support an Air Force investigation.

When the IG team looked at each of these issues, they could find no substantiation. In the case of the number of MOU's, we could find no correlation; in fact, the report goes into a discussion of the correlation between the numbers of MOU's at a university and its overhead rates. In some cases, there are universities with no MOU's but higher overhead rates. So, it's difficult to have a cause and effect relationship.

Based upon my understanding of what Mr. Biddle's concerns were and what the IG Team found, we could not find any evidence of a cozy relationship.

Mr. **Wyden**. Would the gentleman yield?

Mr. **Lent**. I would be happy to yield to the gentleman from Oregon.

Mr. **Wyden**. I appreciate his courtesy.

With respect to this overly cozy relationship between the Government and the contractor, could you amplify what you meant, Mr. Biddle, when you talk about this situation? My colleague has been touching on it.

Mr. **Biddle**. I think we have an overly cozy relationship, extending all the way back to the latter part of the 1970's. For my own efforts, I do not know what has been passed up by the IG Review Team, but we identified over 3 pages just recently, because we were shocked by the fact that there was no indication of partiality. We provided roughly three pages of documents that we thought indicated partiality to this contractor.

The coziness—I will give you one example, because I do not wish to take up too much time on this. But, in 1978, the university was thrust into a situation that perhaps shifted cognizance away from the Department of Defense to the Department of Health and Human Services.

When the situation was brought up to OMB—I forget what Bill Wilkins' role was at that time; but he put in a letter to OMB indicating that he felt it—the cognizance—should remain with the Department of Defense.

I was very surprised to see a letter from Stanford University that must have been 6 pages in length, pointing up all the beautiful relationships that had evolved over a period of years between Stanford and ONR and the level of awareness and support they were receiving from ONR. If you are an oversight agency, you would not expect one of your contractors to be so vocal and adamant about a retained cognizance with them. You just sort of take it as it flows. If there is a shift of cognizance to another agency, you accept it.

That is an example of the type of coziness I was referring to.

Mr. **Wyden**. I am intruding on my colleague's time. I think we would like that letter, and I thank the gentleman for his courtesy.

Mr. **Lent**. Admiral Miller, is "partiality" synonymous in your mind with "cozy," or are they two different things?

Admiral **Miller**. I tried looking up the word "coziness" in the dictionary and could not find it, I must confess. When I asked the question, I phrased it as I considered it should be phrased, in plain simple English, and I did not try to amplify on that.

Mr. **Lent**. When you tasked your investigators, why did you ask them to determine whether ONR personnel were, quote, "not being impartial," unquote in their dealings with Stanford? That's actually what you asked them to do.

Admiral **Miller**. That's correct.

Mr. **Lent**. Is that different than "cozy" or is it the same thing?

Admiral **Miller**. It was not intended to be anything more than a restatement of the problem that was brought to me.

Mr. **Lent**. So, in fact, the real question here is whether the Government's interest is being adequately protected, whether the failure results from negligence or recklessness or deliberate wrongdoing. Isn't that the case?

Admiral **Miller**. Yes, sir, that's correct.

Mr. **Lent**. What investigations are ongoing to determine whether the Government's interest are being protected, and if not, why not?

Admiral **Miller**. There are a number of investigations going into the business aspects, including staff members of this committee who have been out there. The Government Accounting Office which also has been out there, testified earlier this morning. Certainly, DCAA has put substantial resources on this.

But in addition, I have established, as I previously stated, a personnel review team to look at ONR personnel in particular to determine if there is some administrative action that ought to be taken against the people involved over this entire 10-year period.

I chartered this team to look at the entire employment of the Office of Naval Research over the entire period in question. I didn't want to delimit the effort.

In addition to the administrative inquiry that I chartered, the Naval Investigative Service has also initiated an investigation in this area. They are looking into the potential of criminal wrongdoing.

Mr. **Lent**. Let me just ask one final question. It's kind of long. Just look at the facts here, and these were facts found to be true by your investigators and included in your report.

First, they found that Stanford, among all of the other universities, was unique because it has the highest number of MOU's of the 36 universities under ONR cognizance. In fact, it has more than 10 times the number of MOU's of any other of the universities. Of the 102 MOU's Stanford had, approximately 95 of them, or 93 percent, relate to the subject of indirect costs.

Second, your investigators found that the majority of these MOU's were negotiated without the benefit of legal review, without the benefit of audit, both of which are required under the regulations.

Third, DCAA has found that these MOU's may be costing the Government $18 million a year, and has recommended that ONR withdraw from all of them.

Now, these facts, if unexplained, it would seem to me, would tend to support a perception of partiality on the part of ONR towards Stanford. I'd like to give you this opportunity to explain to me and to explain to the committee how the IG concluded that, despite all these facts, no partiality existed?

Admiral **Miller**. The IG team, in their report, looked at or tried to establish a relationship between the number of MOU's at a university and the overhead rates assigned to that university. They could see no correlation at all between the numbers of MOU's and actual overhead rates charged. There are some universities that have no MOU's, but have higher overhead rates.

With regard to the lack of audits and legal reviews of those MOU's, I concur with you that that was a failing of my organization to perform its duty on that campus. But as a direct correlation to a cozy relationship, I can't make that tie.

You, yourself, earlier gave three plausible explanations for that kind of conduct, and I have seen no facts that would allow me to choose among those plausible explanations. I think all of them have a potential for validity in this case.

As far as DCAA——

Mr. **Lent**. Yes, but let me just interrupt you for a minute. You came to the conclusion that there was no partiality. You didn't say that, "Well, there might have been," or "There could have been," you said there was "no partiality."

Admiral **Miller**. They found no evidence of partiality out there, sir. In fact, I have discussed this point with GAO, the GAO investigators, and they also didn't find it.

Mr. **Lent**. Well, I've just given you the evidence. I just rattled off 4 or 5 circumstances, findings upon which the conclusion would be predicated, and despite that, the conclusion was "no partiality."

Admiral **Miller**. That evidence, I believe, sir, could just as easily be evidence of very poor performance on that campus.

Mr. **Lent**. OK. So the fact is that you don't know that partiality was not present, and yet you say that there was no partiality. You're actually saying that there was no evidence of partiality.

Admiral **Miller**. I am saying that I stand by the report, which said that they found no evidence of partiality on Stanford campus. But I will hasten to add that I have commissioned a subsequent personnel investigation, a personnel review, to look at the conduct of the people actually involved in the performance of the Government's business on that campus to see why their performance was as it is, and why it wouldn't have been better, as the taxpayer had a right to expect.

Mr. **Lent**. OK. Thank you, Mr. Chairman.

Mr. **Wyden**. I didn't want to cut the gentleman off. Has the gentleman completed?

Mr. **Lent**. Yes.

Mr. **Wyden**. All right.

Admiral Miller, when the questions began to arise at Stanford concerning their billing practices, they performed an internal study that concluded that the Government owed Stanford approximately $13 million.

Do you put any credence in the university's claim that the Government owes them money, versus the concerns that have been expressed that the university overbilled the taxpayers during the 1980's?

Admiral **Miller**. A copy of that study has been provided to the Special University Team I commissioned to represent the Government. Based upon what I have seen, I would not put any credence in that conclusion.

Mr. **Wyden**. You don't find any evidence, then, that the Government owes money?

Admiral **Miller**. I have seen no evidence that the Government owes Stanford money.

Mr. **Wyden**. Would you characterize Stanford's internal investigation as a good-faith effort, in your view, to get at the kind of problems that have been outlined to the subcommittee today?

Admiral **Miller**. I haven't seen the internal working papers that supported the conclusion that was in the report. The report that was put forward was unsubstantiated, as far as I'm concerned. The conclusions in that report were not substantiated in the report that was released.

Mr. **Wyden**. Do you see other evidence that would indicate an effort by Stanford, a good-faith effort to try to get out these problems?

Admiral **Miller**. Yes, sir, I do. In fact, I was very much gratified by the fact that they are employing one of the Big 6 accounting firms to help them establish adequate internal controls. By bringing in outside advisory groups, it looks like to me they're trying to bring peer review and outside vision into their business operations on campus.

Mr. **Wyden**. But what I'm more interested in is what's taken place to date to the 1980's. Do you feel that there has been a good-faith effort to get to the bottom of the kind of problems that the subcommittee has seen with respect to overbillings during the 1980's?

Admiral **Miller**. I would expect that Stanford right now would be scrubbing all of their cost pools for the period in question, but I have no evidence, in fact, that they are doing that.

Mr. **Wyden**. OK. Admiral, of all the charges that have been discovered by the subcommittee, by the Office of Naval Research, by the DCAA, by the General Accounting Office, have there been any charges brought to light that you are aware of where Stanford was, in effect, first on the scene and discovered the charges themselves?

Admiral **Miller**. Not that I can recall, sir.

Mr. **Wyden**. OK. Do you think that that's acceptable?

Admiral **Miller**. No, sir. When evidence showed that their cost pools contained unallowable charges, I believe a responsible manager would go into the rest of the cost pools and find them before the auditor did.

Mr. **Wyden**. If there has been the kind of pattern of overbilling that's been discussed, why hasn't there been a comprehensive scrubbing of these bills and problems brought to you?

Admiral **Miller**. You're asking a question of me that only Stanford could offer an answer to.

Mr. **Wyden**. But you don't think there's any justification for that not being done, the scrubbing——

Admiral **Miller**. I believe a responsible manager, based upon what is known now, would be scrubbing those cost pools.

Mr. **Wyden**. And why is the Government, in effect, tolerating it? I mean, it hasn't been done at this point, so I think taxpayers listening to this hearing would say that the Government is tolerating it. Shouldn't that be something that the Government directs the university to do and do immediately?

Admiral **Miller**. We have spoken to the university in particular about the years 1981 and 1982, which had come into question, and asked them if they are going to go back and start scrubbing them, and, in fact, were told that they're going to stand by those costs.

Mr. **Wyden**. But have you all directed the university to scrub these accounts and bring problems to you?

Admiral **Miller**. No, sir, we have not. Stanford is still, to the best of my knowledge, standing behind their original submissions.

Mr. **Wyden**. But do you believe that it would be appropriate for your Agency at this point to direct the university to scrub these accounts and bring problems to you?

Admiral **Miller**. You have asked a question that I hadn't previously considered, and before I would direct them, I need to talk to my contracting officers and legal advisors to see if I have that right. But it sounds like a reasonable course of action if, in fact, I have the right.

Mr. **Wyden**. So you think that that would be a reasonable step for your Agency to pursue, and you want to talk to your people about it.

Mr. Biddle, do you think that would be a reasonable step on the part of Admiral Miller at this point?

Mr. **Biddle**. I think it would be reasonable, but I'm not encouraged by it. I'll give you an example. We have taken heart in the fact that we have a Big 6 firm coming in to assist in review of costs, in effect to review internal controls.

At the initial inquiry that I had with the partner from Arthur Andersen, I questioned him about what his experience was in reviewing internal controls at educational institutions, especially ones that had high research procurement levels, and he said, "I have none."

Now, to me, that indicated that there was an expressed desire on the part of the university not so much to get great expertise as to get some great shadow effect of a Big 6 firm.

I'm not encouraged that Stanford would be so forthcoming. Most of the instances I'm aware of—where there were questioned costs identified by DCAA or GAO—were not situations where Stanford forthrightly stepped up in a sense of a voluntary disclosure and said, "Here is a situation that we think is remiss." It was first noted by Government and then responded to by the university.

Mr. **Wyden**. Well, I think that's a very significant point, Mr. Biddle, because what you've told me, as I understand it, is that it would be a reasonable concept to have this kind of scrubbing, but that, in this case, it wouldn't do much good because there's not the commitment to really turn this problem around, and I find that a very significant statement.

Now, Admiral, do you believe that Stanford's accounting procedures and internal controls were lax during the 1980's?

Admiral **Miller**. Yes, sir, I do.

Mr. **Wyden**. And in what respect?

Admiral **Miller**. I do not find any evidence that Stanford management was aware of what was going into the cost pools, and therefore what was being charged off to the Government.

We have heard evidence all morning long and into the afternoon about unallowable costs contained in these cost pools, costs that—without question, such as alcohol-related costs—would not be accepted by the Government as allowable under any circumstances, let alone with respect to support for research.

Mr. **Wyden**. Do you think that the necessary controls have actually been implemented, and I want to use that word specifically, in the accounting system as of this time?

Admiral **Miller**. I know of no changes in the accounting system. All I know about is initiatives to correct them.

Mr. **Wyden**. That doesn't sound to me that the university is yet being responsible in its relationship with the Government. Is that correct?

Admiral **Miller**. Their response to the inadequate internal controls, I believe, is their bringing in of the Arthur Andersen firm. I consider that a responsible act, but it has not yet resulted, to my knowledge, in any obvious changes in those internal controls.

Mr. **Dingell**. Would the gentleman yield?

Mr. **Wyden**. I'd be happy to.

Mr. **Dingell**. I am somewhat awash in this myself, trying to understand what the internal controls are. If you have internal controls that don't work, if it's because of lack of competence, you'll find mistakes all over the place. Is that right?

Admiral **Miller**. Yes, sir.

Mr. **Dingell**. But if you find internal controls that don't work because they are conferring advantage to one party or the other party on a uniform basis, then you have to construe this as meaning that something different is going on, don't you?

Admiral **Miller**. The lack of internal controls and their effect on the cost pools, I believe, has resulted in all costs relating to a certain activity of the university appearing in cost pools that would be subsequently charged to the Government. All costs. I see no evidence that they're trying to pull out anything.

Mr. **Dingell**. And no evidence that they tried to keep out anything.

Admiral **Miller**. That's correct.

Mr. **Dingell**. And no evidence that they were failing to insert into these cost pools things that should have been there.

Admiral **Miller**. That's correct. We're finding evidence that, in fact, totally unallowable costs, like some of those mentioned this morning, are in those costs pools.

Mr. **Dingell**. Admiral, what would I infer from this? Would I infer here that there's fraud, or just simply sharp practice, or what conclusion would I be driven to if I were to analyze it through your eyes?

Admiral **Miller**. I don't have any evidence today of a fraudulent act at Stanford.

Mr. **Dingell**. Could you rule out, then, sharp practices?

Admiral **Miller**. I'm not sure how you're defining "sharp practices," but I would certainly subscribe to the comment made earlier that Stanford was particularly aggressive in trying to recoup costs in support of Government research.

Mr. **Dingell**. Regardless of whether they were allowed or not?

Admiral **Miller**. In many instances, we have seen examples of their trying to recoup costs that were not allowed.

Mr. **Wyden**. I thank the chairman.

My point, Admiral, is that you have told this member that the necessary controls have not been implemented; as of this point, the accounting system hasn't been fixed. What I am concerned about is given those problems, whether Stanford currently can be a responsible contractor in its relationship with the government. And it seems to me, based on what you have said, they cannot be a presently responsible contractor, and I would like you to tell me whether you think they are, or whether they aren't today.

Admiral **Miller**. We have recently discussed within my office this particular question, including the responsiveness of this contractor, and what administrative or other measures might be taken as a result of this. The conclusion is, based upon not only what they have in place today, but based upon the activities that we have seen to improve their accounting practices, we do not have sufficient basis for taking any punitive action as you would with an unresponsible contractor.

That having been said, I think it is important to add that based upon some of the things we have heard this morning, which we had not previously heard from the General Accounting Office, for example, that I have directed the head of my Special University Team and my corporate counsel to meet and work with DCAA and the Naval Investigative Service and the GAO, if that is permitted by the committee, to develop further facts in this case.

Mr. **Dingell**. Would the gentleman yield?

Mr. **Wyden**. I would be happy to.

Mr. **Dingell**. We have a little problem with regard to certification. There were at least 2 years in which Stanford certified that there were no unallowable costs in their submissions. Is that right?

Admiral **Miller**. That is correct, sir.

Mr. **Dingell**. As I understand, certification improperly made is a criminal act; is that right?

Admiral **Miller**. I have discussed that particular point with counsel, and have been advised that that is a difficult point to make, and that based on our current evidence—and all I can say is based upon what I know right now—that I don't have a basis to conclude that point, but that is one of the reasons that we are going to be working very closely with the GAO—with the committee's permission, of course—and with DCAA, to address that issue.

Mr. **Dingell**. Would I be fair in inferring that this is a matter into which you are going to be inquiring most diligently?

Admiral **Miller**. Yes, sir, you may infer that.

Mr. **Dingell**. I find myself curious. Certification is required by Federal statute. It says that you certify something, and you do so under pain of criminal prosecution. Is that right?

Admiral **Miller**. I am getting into an area of law, sir, where I have no competence at all, and I would need legal assistance in order to address this adequately.

Mr. **Dingell**. You wouldn't want to give me the impression that it didn't mean anything, that you could certify to anything you wanted and you weren't going to be held accountable for it, would you?

Admiral **Miller**. No, sir, I don't believe when I sign something that it means nothing, and I anticipate similar respect from others who sign documents.

Mr. **Dingell**. I thank the gentleman.

Mr. **Wyden**. I thank the chairman.

Admiral, suspension and debarment procedures are in place in the Federal Government, and they are there not to be punitive in nature, but rather to protect the taxpayers' interest at any point in time.

Now if the subcommittee can't be sure that Stanford has not only taken the necessary corrective action, but implemented those corrective actions with the controls, with the accounting procedures, I think the taxpayers are going to say why shouldn't they be suspended in order to protect the taxpayers' interest?

Why hasn't the Office of Naval Research taken this action, the question of suspending the university, until it takes the necessary steps to protect the taxpayers' interest?

Admiral **Miller**. The potential for suspension and debarment was among those potential actions the Government could take against Stanford, and among those that we discussed with counsel.

In fact, I discussed it in particular with a counsel who has extensive experience in suspension and debarment proceedings with Government contractors, and I have been advised that the types of remedies that we would seek from a contractor through suspension or debarment are similar to those that, in fact, Stanford has put in place. And so at the present time, we would probably not have the basis for taking that action.

Mr. **Wyden**. So suspension or debarment is not under consideration at this point?

Admiral **Miller**. Suspension or debarment is not sufficiently justified, based on what I know today, but it remains among the potential actions that the Government may take, based upon any facts that may be developed in the future.

Mr. **Wyden**. Are you concerned about the situation of giving Stanford additional time to implement these internal controls and accounting changes, letting Federal dollars flow to the university, producing a situation where the Government essentially is still at risk in the process?

Admiral **Miller**. One of the things that we have accomplished at Stanford University through the Special Team that we formed is a negotiated agreement with the university that any changes that we might make this year with regard to MOU's or in setting their rates is retroactive to the beginning of this fiscal year, to October 1, 1990. So I believe that the Government's exposure this year has been contained, as was one of my original priorities in putting together our action.

Mr. **Wyden**. And you would anticipate using that kind of remedy, the ability to collect money retroactively, as one tool to protect the taxpayers from this point on?

Admiral **Miller**. That is correct, sir, because if we find, for example, that the billing rate should be lowered, and refigure how much the university has been paid over the fiscal year to date and, if they have been overpaid, then on the next billing, that billing would be decremented.

Mr. **Wyden**. Let me recognize my colleagues at this time, the gentleman from Georgia or the gentleman from Michigan.

The gentleman from Georgia.

Mr. **Rowland**. Thank you, Mr. Chairman.

I want to ask Mr. Dolan a couple of questions.

Mr. Dolan, as Director of the university Business Affairs Office, what is your view of what went wrong at Stanford?

Mr. **Dolan**. Well, sir, I feel that we did not have timely auditing to cover the financial controls and the financial management at that university, in addition to some failures that were made within our own organization with respect to requesting auditing.

Mr. **Rowland**. Wasn't it up to the Navy to call in these audits?

Mr. **Dolan**. Sorry, sir?

Mr. **Rowland**. Wasn't it up to the Navy to call in these audits?

Mr. **Dolan**. Yes, sir.

Mr. **Rowland**. Why wasn't your office more vigilant, then, in dealing with that?

Mr. **Dolan**. Sir, we have an operating guide for our contracting officers that outlines the procedures that they are to follow in connection with the negotiation of indirect cost rates and MOU's with special studies. Amongst those procedures is a requirement to seek audit support.

Mr. **Rowland**. But the audits weren't sought, were they?

Mr. **Dolan**. That is correct, they were not.

Mr. **Rowland**. So then the vigilance wasn't there that should have been?

Mr. **Dolan**. That is correct.

Mr. **Rowland**. Mr. Simpson, you were the Resident Representative at Stanford for a number of years, I believe.

Mr. **Simpson**. Correct.

Mr. **Rowland**. How could Paul Biddle immediately see major problems at Stanford that you did nothing about for years?

Mr. **Simpson**. Mr. Biddle identified the lack of audits that we weren't getting when he came aboard, and proceeded to get some movement in that direction.

Mr. **Wyden**. Let me just interrupt the gentleman from Georgia. As Chairman Dingell reminds us, the mikes frequently don't work very well in this room, and Mr. Simpson, I don't think any of us could get your response to the gentleman from Georgia, and if you could just repeat that.

Mr. **Rowland**. Repeat his answer?

Mr. **Wyden**. Could you hear him? I couldn't hear him.

Mr. **Rowland**. I did not.

Mr. **Simpson**. Would you repeat the question, then, please?

Mr. **Rowland**. Well, you were the Resident Representative at Stanford for a number of years?

Mr. **Simpson**. That is correct.

Mr. **Rowland**. 10 years. How could Paul Biddle immediately see a major problem at Stanford that you did nothing about for these years?

Mr. **Simpson**. I don't know about that, but during my tenure as the ACO, I did try to get audits when I could, and I was advised by DCAA at different times that universities were low risk contractors, and they wanted to put their resources in areas of greater pay-off.

Mr. **Rowland**. Well, how did the Navy sign all these MOU's without doing the required legal and audit work that should have been done?

Mr. **Simpson**. My understanding, when the initial MOU's were put in place in 1979, the DCAA auditors were in attendance at the negotiation of those agreements.

Mr. **Dingell**. Would the gentleman yield?

Did you say that the auditors were in attendance during the negotiation?

Mr. **Simpson**. That is my understanding.

Mr. **Dingell**. Were there legal opinions, and were there consultations with the legal people also?

Mr. **Simpson**. Legal review was not made. It wasn't required.

Mr. **Dingell**. No legal review was made.

Did the auditors have a chance to do a prior study or analysis before the MOU's were agreed to?

Mr. **Simpson**. In a number of cases, yes.

Mr. **Dingell**. And when you say in a number of cases, "yes," I would infer from that statement that you are telling me in a number of cases, no.

Mr. **Simpson**. That is correct. Some MOU's were more administrative in nature than they were——

Mr. **Dingell**. Beg your pardon?

Mr. **Simpson**. Some MOU's were administrative in nature.

Mr. **Dingell**. But a goodly number of them dealt with financial questions and questions of compensation; is that right?

Mr. **Simpson**. That is correct.

Mr. **Dingell**. And even the other questions which were administrative in character also dealt with financial questions, did they not?

Mr. **Simpson**. Yes, sir.

Mr. **Dingell**. Now if I am an auditor, and I am called in, and I sit in a room, and I hear a brief discussion and then the signing takes place, have I been properly consulted in connection with the business that is to transpire, or not? Particularly if it involves the signing of an MOU between, let's say, Stanford University and a Government contracting agency?

Mr. **Simpson**. Well, it is my understanding the auditors were furnished copies of the proposed MOU before any of the negotiations took place.

Mr. **Dingell**. Provided copies when?

Mr. **Simpson**. It could be 30 days, it could be a couple of months ahead of time.

Mr. **Dingell**. Could have been 30 minutes?

Mr. **Simpson**. Unlikely.

Mr. **Dingell**. Pardon?

Mr. **Simpson**. That would be unlikely.

Mr. **Dingell**. Unlikely.

Would it be likely that they were given 30 days?

Mr. **Simpson**. I think so, yes.

Mr. **Dingell**. But no legal opinions and no legal assessment?

Mr. **Simpson**. No legal opinions, no.

Mr. **Dingell**. I thank the gentleman for yielding to me.

Mr. **Rowland**. I have no further questions.

Mr. **Wyden**. The gentleman from Michigan?

Mr. **Dingell**. Mr. Chairman, just very briefly.

Mr. Dolan, when did you and Mr. Simpson first discover the events that were associated with the questions that are now inquired into by this committee relative to overcharging and improper charging by Stanford?

Mr. **Dolan**. I first discovered it, sir, when we received notice of the FOIA request and then the information was submitted to my office.

Mr. **Dingell**. When was that?

Mr. **Dolan**. I believe it was in June 1990.

Mr. **Dingell**. In June 1990. Who submitted that request, if you please?

Mr. **Dolan**. The Freedom of Information Act?

Mr. **Dingell**. Yes. Who submitted the FOIA request?

Mr. **Dolan**. It was the San Jose Mercury News.

Mr. **Dingell**. Beg your pardon?

Mr. **Dolan**. The San Jose Mercury News. That is my understanding.

Mr. **Dingell**. So then it was the press that discovered it?

Mr. **Dolan**. I was responding to your question of when did I first find out these allegations that Mr. Biddle was making.

Mr. **Dingell**. So the press really brought it to the attention of your office; is that right?

Mr. **Dolan**. That is correct.

Mr. **Dingell**. That was, you say, in June 1990?

Mr. **Dolan**. Well, I believe the FOIA request was in May or June 1990.

Mr. **Dingell**. What did you do about this?

Mr. **Dolan**. Immediately when I became aware of a particular piece of information that was included in the FOIA request, I requested, via my director, that the Assistant Chief of Naval Research have the IG look at these allegations. I submitted that request, sir.

Mr. **Dingell**. Now, Mr. Biddle, when did you first become aware of this information?

Mr. **Biddle**. I believe I came into Stanford about mid-October. Within the first week that I——

Mr. **Dingell**. Of what year?

Mr. **Biddle**. Of 1988.

Mr. **Dingell**. 1988.

Mr. **Biddle**. And within the first week that I was there, I was invited to attend a meeting put on by Janet Sweet, the assistant controller at Stanford, to brief us on the library component of the overhead. Upon my return to the office, I advised Rob Simpson that I thought we were being ripped off because of the absence of documents.

Mr. **Dingell**. This was in October 1988?

Mr. **Biddle**. It was in October 1988.

Mr. **Dingell**. In the summer of 1988?

Mr. **Biddle**. Beg your pardon?

Mr. **Dingell**. Summer 1988?

Mr. **Biddle**. October 1988.

Mr. **Dingell**. October. All right.

Mr. **Biddle**. We bantered about this thought for quite some time. By February it was very significant, and I started documenting the difficulties associated with the development of overhead. I chose in particular the library study. As I went to the file drawer, I was told by Jack Ducey and Rob Simpson, if you think they're such damned bad overhead rates, why don't you detail why they are so bad? So, I just pulled one out, the library study was the thickest folder, and chose that to initiate the documented critiquing of the development of overhead components.

Mr. **Dingell**. Now say that again, please. I want to follow this. You asked for a particular folder and the library pulled out a different folder?

Mr. **Biddle**. No, no, no—clarification. There was some disbelief on the part of Jack Ducey and Rob Simpson that we would have a problem with the overheads, which I feel now is rather unacceptable because of all the comments that have been made by the HHS in 1983, which both of them were privy to. They should have been very much aware that there were problems with overheads as far back as that, if not previously, but in February I agreed with Jack and Rob——

Mr. **Dingell**. This is February of what year?

Mr. **Biddle**. 1989.

Mr. **Dingell**. 1989.

Mr. **Biddle**. That I would document one particular component of the overhead. You have to remember at this time emphasis was being placed upon administrative problems at Stanford.

I had no staff. My staff had departed and I was left alone for 5 months to handle all the administrative workload within an office.

The point was made to me, well, if you think they're so damn bad, and I believe that was the phrase or if not that, it was so bad, why don't you go in and show us how they're so bad, and I said what component of the overhead do you wish me to review?

They said you choose the component you want to review.

I went over into our office adjacent where we have our files, opened the overhead drawer, saw several components of overhead—as you have heard, there are various special studies—and just reached in and the thickest folder was the library component, and that was the one that I chose.

Mr. DINGELL. What did you do then? Did you make this information available to your superiors?

Mr. BIDDLE. There was—well, it took time to document it. It wasn't immediately——

Mr. DINGELL. Beg pardon?

Mr. BIDDLE. There was not an immediate turn-around in February. It required time to go through and analyze it but, yes, there were two letters put out. One I believe was put out in March 1989 and a second one—I recall exactly because I was working on a holiday—July 4, 1989. It was then I put out a second letter.

Mr. DINGELL. These letters were put out by you?

Mr. BIDDLE. By me.

Mr. DINGELL. To?

Mr. BIDDLE. To Stanford University detailing inadequacies within the development of the library component of overheads.

Mr. DINGELL. Were those letters cleared with your superiors?

Mr. BIDDLE. Yes. Most definitely.

We had a policy, which I could identify in the area of partiality, that I would send all my reports up to Rob at that time, and there was good reason for that. I don't mean to be critical of the fact that they were being sent up. There would be considerable exchange of inputs about choice of wording.

This ultimately led to my dissatisfaction with that arrangement and a desire to scrub that down the road.

One particular instance of that point—I'm going to divert from overhead since we're talking about the rewrite ability—when I found weaknesses in the voucher area of the university, I wrote a rather stinging letter to the Stanford Controller's office setting them on notice and wanting to advice DCAA of the shortcoming. The assistant controller requested that Rob Simpson intervene and have the letter retracted. I still believe that the positions at that time were valid, but the letter was retracted eventually by ONR.

Mr. DINGELL. The letter was retracted? You mean your letter was retracted?

Mr. BIDDLE. Yes.

Mr. DINGELL. Who retracted it?

Mr. BIDDLE. My superior, Rob Simpson.

Mr. DINGELL. Who?

Mr. BIDDLE. Rob Simpson.

Mr. DINGELL. Mr. Simpson?

Mr. SIMPSON. At question was the tone of the letter.

Mr. DINGELL. Why did you retract this letter?

Mr. **Simpson**. We didn't retract the letter. We retracted the tone of the letter.

Mr. **Dingell**. You retracted the tone. That is an interesting statement.

How does one retract the tone and not retract the letter?

Mr. **Simpson**. We would like to have him write it over and use a more professional tone when he was addressing the university as a representative of the Government.

Mr. **Dingell**. Was the letter then resubmitted or not?

Mr. **Biddle**. We have two different instances of letters——

Mr. **Dingell**. Beg pardon?

Mr. **Biddle**. We have two different instances of those types of things happening.

I am very forceful when I find things are improper and I feel there has to be a little bit of passion in the contract administration function.

Mr. **Dingell**. You say then that you had two of your letters retracted?

Mr. **Biddle**. Yes.

Mr. **Dingell**. What was the second letter that was retracted?

Mr. **Biddle**. I can't recall now. They are normally one-pagers but they are quite to the point and they are rather caustic and the intent is to have correction.

I am not trying to develop a relationship.

The concept of what I call—what DHHS referred to as accommodation by ONR to the university in 1983 and which I characterized as "coziness" is not on my agenda. My agenda was——

Mr. **Dingell**. Did Mr. Simpson have that letter retracted too?

Mr. **Biddle**. I believe neither one of those letters actually went through. It was really a rather involved process of an exchange of 6 or 7 positions on how it should be written.

Mr. **Dingell**. Then maybe Mr. Simpson could help us. Mr. Simpson, did you stop these letters from going out?

Mr. **Simpson**. They weren't letters. They were——

Mr. **Dingell**. Beg pardon?

Mr. **Simpson**. I think what Mr. Biddle is talking about is parts of a critique he was doing on the Stanford Library Study.

Mr. **Dingell**. Yes, but he said he wanted to send two letters out, and neither of which went out. Now if they didn't go out, I assume he wanted to send them out. I assume somebody else didn't. You were his superior. Did you stop them from going out? He didn't stop them. Did you?

Mr. **Simpson**. I am not familiar with the letters he is talking about.

Mr. **Dingell**. You are not familiar?

Mr. **Simpson**. No.

Mr. **Dingell**. Well, you were apparently familiar with one enough to say that you objected to the tone.

Mr. **Simpson**. That's correct.

Mr. **Dingell**. You didn't object to the letter but you objected to the tone. Now is that right?

Mr. **Simpson**. He was talking about two other letters.

Mr. **Dingell**. But if you are not familiar with the letter, how can you tell me that you didn't object to the letter but you objected to the tone and then to say that you stopped it but to say that you are not familiar with it?

I am having some difficulty with this. Could you help me.

Mr. **Simpson**. I thought Mr. Biddle was describing two other letters when he was——

Mr. **Dingell**. Let's stay with the first and then let's go to the other two.

I understood there were only two and not three.

There were three letters which were stopped? Two. OK, there were two.

We have discussed the first. You stopped it because of the tone, is that right?

Mr. **Simpson**. He sent the letters.

Mr. **Dingell**. Beg pardon?

Mr. **Simpson**. No, he sent the letters.

Mr. **Dingell**. The letter was sent. Was the letter sent, Mr. Biddle?

Mr. **Biddle**. The letter was sent to Janet Sweet. Janet Sweet complained of its contents. She didn't want this being existent.

She asked that Rob Simpson retract it on the part of ONR and I understand she said you have the authority to do that—you're his boss.

Now this to me impacts an ACO negatively, especially if there were grounds for it.

Mr. **Dingell**. So it was Stanford that had the letter retracted, is that right?

Mr. **Biddle**. Stanford initiated the request.

Mr. **Dingell**. Beg pardon?

Mr. **Simpson**. The letter wasn't retracted.

Mr. **Dingell**. The letter wasn't retracted?

Mr. **Simpson**. The tone of it.

Mr. **Dingell**. How is a letter not retracted when Mr. Biddle tells me it was? Either the letter was retracted or the letter was not retracted.

Stanford asked you to retract it. Did you retract it?

Mr. **Simpson**. I did not retract it.

Mr. **Dingell**. Does the letter still stand then?

Mr. **Simpson**. Yes, it does.

Mr. **Dingell**. Does it still stand, Mr. Biddle?

Mr. **Biddle**. I'm glad to hear that today.

Mr. **Dingell**. No, no, no. I don't want you to hear something for the first time.

I am hearing it for the first time.

I want you to tell me what you know.

Mr. **Biddle**. My understanding is that it was retracted and it was forcefully retracted also. It involved other people.

Mr. **Dingell**. It was forcefully retracted? Was it done in writing?

Mr. **Biddle**. Let me characterize that. It was not a matter of a casual request: If you find this to be unacceptable in its language, would you please advise to pull it back? That to me is what I call a casual request for retraction.

Mr. **Dingell**. So what kind of communication did you receive instructing you to retract this letter?

Mr. **Biddle**. There was another party in the university involved in this. It involved myself, the Director of Sponsored Projects at Stanford University and Janet Sweet.

Now Janet Sweet was involved because it involved one of her subordinates.

Mr. **Dingell**. And she got on the phone to you, Mr. Simpson at this time, did she?

Did she speak to you? Pardon?

Mr. **Simpson**. I don't remember any——

Mr. **Dingell**. Well, to whom did she speak? Do you know? Anybody know?

Mr. **Simpson**. I believe they sent a letter to——

Mr. **Dingell**. Who is they?

Mr. **Simpson**. They, Stanford, sent a letter to the ONR complaining about the letter.

Mr. **Dingell**. Complaining about the letter.

Mr. **Simpson**. Yes.

Mr. **Dingell**. All right. Now to whom was that letter sent?

Mr. **Simpson**. I think it was sent to me.

Mr. **Dingell**. Sent to you?

Mr. **Simpson**. Yes.

Mr. **Dingell**. What did you do when you received that?

Mr. **Simpson**. I talked to Mr. Biddle about it.

Mr. **Dingell**. You talked to Mr. Biddle about it?

Mr. **Simpson**. Yes.

Mr. **Dingell**. And what did you tell Mr. Biddle?

Mr. **Simpson**. I told him I didn't think the tone of the letter was very professional.

Mr. **Dingell**. Did you disagree with the content of the letter?

Mr. **Simpson**. I didn't disagree with the content of the letter, no.

Mr. **Dingell**. Mr. Biddle, did Mr. Simpson disagree with the tone of the letter or did he disagree with the substance?

Mr. **Biddle**. He definitely disagreed with the tone of the letter.

Mr. **Dingell**. How about the substance?

Mr. **Biddle**. With respect to the substance, we had an exchange by electronic mail through the campus E-Mail. There is full documentation of the fact that Janet Sweet was coordinating directly with Rob Simpson on this, that she wanted that letter retracted because it did not appear favorable to Stanford.

Mr. **Dingell**. Because what?

Mr. **Biddle**. It did not appear favorable to Stanford, that these breakdowns in internal controls in the voucher area could be occurring.

Mr. **Dingell**. Was there any quarrel about the content of the letter?

Mr. **Biddle**. Beg your pardon?

Mr. **Dingell**. Was there any quarrel about the content of the letter? With Stanford or with Mr. Simpson? Mr. Simpson appears to have reservations.

Mr. **Biddle**. The direction I received on that letter, and I never thought this would be such a significant letter at the time, but the instruction I received was that unless I could get corroboration and support from Fred Bentley to support the contentions I had identified in the letter—now this is a University staffer who has the interface with——

Mr. Dingell. Unless you receive corroboration from Bentley, a University staffer?

Mr. Biddle. Right.

Mr. Dingell. That you would do what?

Mr. Biddle. That I was to retract the letter.

Mr. Dingell. But this was an instruction?

Mr. Biddle. That was an instruction.

Mr. Dingell. Now Mr. Simpson, you have heard this. Is this a fair statement or not?

Mr. Simpson. No, it isn't.

Mr. Dingell. Now you have said it is not a fair statement——

Mr. Simpson. To my recollection it was nothing like that.

Mr. Dingell. Will you inform me then in what way this is not a fair statement?

What has Mr. Biddle told the committee that you differ with or that is not truthful?

Mr. Simpson. To my recollection I did not ask him to pull the letter.

Mr. Dingell. You did not?

Mr. Simpson. No.

Mr. Dingell. Was this done in writing, Mr. Biddle, or was this done in a phone call?

Mr. Biddle. Please——

Mr. Dingell. Was this done in a phone call or face-to-face discussion or was it done in writing?

Mr. Biddle. The exchange between Mr. Simpson and myself?

Mr. Dingell. Between Mr. Simpson and yourself.

Mr. Biddle. It was done on the phone but there was reference to it in the Electronic Mails exchanged between myself and the Director of Sponsored Projects.

Mr. Dingell. Did that appear in the Electronic Mail?

Mr. Biddle. Yes.

Mr. Dingell. It did. Pardon? I didn't hear.

The subcommittee staff will be pursuing this with a modest interest.

Did you report any of this to Mr. Dolan, who is your superior, Mr. Simpson?

Mr. Simpson. No, I didn't.

Mr. Dingell. Why not?

Poor Mr. Dolan is sitting there next to you and he has told the committee with great distress that he was not informed of these events until 2 years later when he was approached by the press?

Mr. Simpson. Are you talking about the specific letter now?

Mr. Dingell. I am trying to understand how the communications flow in this office.

Mr. Biddle is saying——

Mr. Simpson. I'd have to——

Mr. Dingell. This is not right and you were saying that you object to the tone. You tell him to withdraw the letter. You have personal discussions with him. You have Electronic Mail communications. You agree with the substance. You don't agree with the tone. You suggest that he get corroboration from a staffer at the university. You do all this at the request of a member of the university staff.

Mr. SIMPSON. I never withdrew the——

Mr. DINGELL. I am trying to find out why with a controversy of this sort you didn't bring this to the attention of poor Mr. Dolan, who sits there unaware of all of these things that are going on.

Now can you help me and tell me why Mr. Dolan was not informed, and he has to hear about it from the press?

Mr. SIMPSON. I don't think this letter had anything to do with——

Mr. DINGELL. Beg pardon?

Mr. SIMPSON. This letter did not have anything to do with the subsequent FOIA.

Mr. DINGELL. The letter didn't have anything to do with what?

Mr. SIMPSON. I don't think so.

Mr. DINGELL. I am having trouble hearing.

Mr. SIMPSON. With the press.

Mr. DINGELL. I'm sorry?

Mr. SIMPSON. If we are talking about the letter that I am thinking about——

Mr. DINGELL. We are talking about the first letter, to which——

Mr. SIMPSON. Mr. Biddle's——

Mr. DINGELL [continuing]. Mr. Biddle has been addressing himself.

Mr. SIMPSON. Mr. Biddle's frustration in dealing with the university.

Mr. DINGELL. And you had him withdraw it?

Mr. SIMPSON. No, I did not have him withdraw it.

Mr. DINGELL. Well, what did you have him do?

Mr. SIMPSON. I just talked to him about it, about the tone of the letter.

Mr. DINGELL. And you talked to him about the tone?

Mr. SIMPSON. Yes.

Mr. DINGELL. Now when you talked to him about the tone, you said, my, my! The tone is terrible!

Or did you say my, my, the tone is terrible, withdraw it!

Mr. SIMPSON. I just said the tone is terrible.

Mr. DINGELL. You didn't tell him to withdraw it?

Mr. SIMPSON. No.

Mr. DINGELL. Why is it he has the distinct impression that you told him to withdraw it?

Mr. SIMPSON. You'll have to ask Mr. Biddle.

Mr. DINGELL. Beg pardon?

Mr. SIMPSON. You'll have to ask Mr. Biddle. I can't——

Mr. DINGELL. Well, Mr. Biddle is sitting there as confused as I am and I am trying to get you to help me.

Mr. SIMPSON. I am quite confused about it also.

Mr. DINGELL. Beg pardon?

Mr. SIMPSON. I am confused about it also.

Mr. DINGELL. All right, then, let us address then the second letter, now that we are thoroughly confused with regard to the first.

What about this second letter? Did you withdraw it also, Mr. Biddle?

Mr. **Biddle**. That would be—let me go into that one.

We're a little bit off the library component, and when I first recognized it but I think there is value in that.

We had a Memorandum of Understanding that I was supposed to sign and you have to understand when you come into a situation as complex as Stanford you've got a ramp-up. You have to have time to absorb and understand.

So in the beginning I relied heavily upon the advice provided to me by the people who were superior to me and who had been to Stanford before.

When I began to look at some of the MOU's though, I was a little bit reluctant, and I balked at signing the memorandum. I didn't think there was adequate support for the types of cost reimbursement that were occurring. I was, nevertheless instructed to sign a Memoranda of Understanding by Mr. Simpson.

I did, because that was an instruction provided to me and far be it from me not to obey.

Mr. **Dingell**. Who provided that instruction to you?

Mr. **Biddle**. Mr. Simpson.

Mr. **Dingell**. And he said—now what did Mr. Simpson tell you that he was to do now?

Mr. **Biddle**. To a memoranda that I was not supportive of, he directed me to sign it over the phone.

Mr. **Dingell**. He directed you to sign a memoranda of which you were not supportive?

Mr. **Biddle**. Correct. So, what I did is, I had the Procurement Assistant type over the top of my signature "signed at the instruction of the"—I think it was—"ONR at Monterey" or "Rob Simpson" or something like this.

That was provided to the university and I received a call that said, take that back, you'll sign that without that type of an admonishment to the signature——

Mr. **Dingell**. Now who told you that?

Mr. **Biddle**. Mr. Simpson.

Mr. **Dingell**. Mr. Simpson! Why would you do a thing like that, I wonder?

Mr. **Simpson**. I have no recollection of that, sir.

Mr. **Dingell**. You do not remember this?

Mr. **Simpson**. No, I do not.

Mr. **Dingell**. Sitting here in the committee, trying to assist us to reconstruct it, does not help your recollection at all?

Mr. **Simpson**. No, sir.

Mr. **Dingell**. Well, I think we are probably going to have to request you to present yourself for some further interviews by the staff, because we seem to be using time that could be better used. Mr. Kennedy is sitting here with a look of profound distress on his face, I do not want to keep him waiting any longer than we should, and I am sure you will be available for appropriate interviews by the staff on this matter.

Mr. Dolan, can you tell us why it is that Mr. Simpson has never informed you of these controversies which exist under his administration?

Mr. **Dolan**. No, sir, I cannot.

Mr. **Dingell**. My word.

Well, thank you, Mr. Chairman.

Mr. **Wyden**. I thank the gentleman.

The hour is late, but do any of our other colleagues, the gentleman from New York, the gentleman from Minnesota, have any other questions now?

Mr. **Lent**. Well, I realize the hour is late, but I just wanted to ask Mr. Simpson a couple of more questions, not about the letter.

Mr. Simpson, you were the Resident Representative at Stanford for the entire period, 1980 to 1988. Is that correct?

Mr. **Simpson**. That is correct.

Mr. **Lent**. We have heard some testimony about an allegation that there was a "cozy relationship" between ONR and the people at Stanford. In that connection, they are probably talking about you. Wouldn't you say that?

Mr. **Simpson**. Yes, I was the Resident Representative at that time.

Mr. **Lent**. Mr. Simpson, did anyone at Stanford ever offer you anything of value to enter into an MOU or not to obtain a business clearance for an MOU or not to request a required DCAA audit?

Mr. **Simpson**. No, sir.

Mr. **Lent**. That never happened? Did you know that audits and legal opinions were required in the form of a business clearance before entering into an MOU? You knew that?

Mr. **Simpson**. Legal was—a legal review was not required.

Mr. **Lent**. My understanding was that a legal opinion was required on every MOU, but it was not obtained on any of these.

Mr. **Simpson**. Not according to our guides, no, sir.

Mr. **Lent**. Admiral Miller, is that the case?

Admiral **Miller**. Obtaining a legal review, to the best of my recollection, was not a documented requirement during the entire period of the 1980's. It is certainly part of our existing regulations.

Mr. **Lent**. Requiring an audit was required?

Admiral **Miller**. Yes, sir, it was.

Mr. **Lent**. An audit was required?

Admiral **Miller**. Yes, sir, it was.

Mr. **Lent**. Did you, Mr. Simpson, ever request an audit?

Mr. **Simpson**. Yes. I requested an audit of the library study in 1984.

Mr. **Dingell**. I did not hear the answer to that question.

Mr. **Simpson**. I requested an audit of the library study in 1984.

Mr. **Dingell**. In 1984?

Mr. **Simpson**. That is when the audit request went out, yes.

Mr. **Lent**. Did you request an audit for any of the MOU's you approved?

Mr. **Simpson**. No, sir.

Mr. **Lent**. Why not? That was required.

Mr. **Simpson**. Well, during the time I was there, the DCAA staff consisted of between 2 and 3 people, 1 or 2 of them as trainees, and we had an audit resource problem during that period.

Mr. **Lent**. Well, now, let us get to this. You were the guy in charge of requesting an audit——

Mr. **Simpson**. That is correct.

Mr. **Lent** [continuing]. On MOU's, and you did not do it. Now, what I want you to do is to tell us why, despite the fact that the number of MOU's at Stanford was over 10 times the amount of MOU's at any other university, why you did not once ask for the required audit?

Mr. **Simpson**. OK. I picked up the responsibility for negotiating the MOU's in 1983. Most or better than half of them were already negotiated.

Mr. **Lent**. On the ones that you did negotiate, you did not request an audit?

Mr. **Simpson**. That is correct, sir.

Mr. **Lent**. Why did you not request an audit?

Mr. **Simpson**. I have no answer for that, sir.

Mr. **Lent**. Well, without an audit, are you not negotiating at a very severe disadvantage? Aren't you, for all intents and purposes, totally, then, dependent on Stanford's data?

Mr. **Simpson**. Yes, but we in our office reviewed that data ourselves.

Mr. **Lent**. Without benefit of audit.

Mr. **Simpson**. In some cases, yes.

Mr. **Lent**. Are you an auditor?

Mr. **Simpson**. I used to be an auditor, sir, yes.

Mr. **Lent**. OK.

Mr. Dolan, you were in ONR's Office of Business Affairs during the time the required audits at Stanford were not being performed. Is that correct?

Mr. **Dolan**. Yes, sir.

Mr. **Lent**. Were you aware that these required audits were not being performed?

Mr. **Dolan**. No, sir, I was not.

Mr. **Lent**. Did anyone out there notice that the required audits were not taking place?

Mr. **Dolan**. There was a requirement in our review guide.

Mr. **Lent**. Yes, we know about the requirement, but did anyone notice that the requirement was not being complied with?

Mr. **Dolan**. Not to my knowledge, sir.

Mr. **Lent**. Why not?

Mr. **Dolan**. The control mechanism in the guide obviously broke down.

Mr. **Lent**. Mr. Dolan, at one point, you asked the Office of Management and Budget to side with ONR against the Department of Health and Human Services on the question of audits. Why did you do this?

Mr. **Dolan**. I do not recall that, sir.

Mr. **Lent**. In 1982, Mr. Simpson, there was a controversy over which Agency, ONR or HHS, should have cognizance over Stanford. Do you recall that?

Mr. **Simpson**. In 1982?

Mr. **Lent**. Yes.

Mr. **Simpson**. In 1983, the DHHS asked to participate in the negotiation of the overhead rate for 1984.

Mr. **Lent**. OK. Make it 1983. Do you recall that in 1983?

Mr. **Simpson**. Yes, I do.

Mr. **Lent**. What was your role in ensuring that ONR retained cognizance over Stanford?

Mr. **Simpson**. I had no role in that, sir.

Mr. **Lent**. Stanford's associate comptroller—and I believe her name has come up earlier—what is her name? Janet Sweet?

Mr. **Simpson**. Yes.

Mr. **Lent**. She wrote a letter to ONR's Regional Manager supporting the retention of ONR cognizance. Is that correct?

Mr. **Simpson**. I am not familiar with that letter, sir.

Mr. **Lent**. If a letter was written by Franklin Riddle, do you recall that?

There was a flap over who should have cognizance, ONR or HHS, and letters were written saying "Let us keep ONR," and they were written by people at Stanford University, namely Mr. Riddle, the associate comptroller who is going to testify about this in a few minutes.

Are you aware of that?

Mr. **Simpson**. I am afraid I am not aware of that letter, sir.

Mr. **Lent**. OK.

Is it unusual for an institution to express a preference for one Agency's cognizance over another?

Mr. **Simpson**. I do not know what would go on at any other university, other than Stanford, at that time, sir.

Mr. **Lent**. OK.

Mr. Chairman, I see the red light is on, and I want to move on, as well.

Mr. **Dingell**. The Chair thanks the gentleman.

Admiral, we have had recommendations from DCAA and from HHS that the MOU's should be cancelled. What are your feelings on that matter?

Admiral **Miller**. We have put in place a very aggressive schedule for the review of those MOU's. In fact, that schedule——

Mr. **Dingell**. Why not cancel them and then review them? Why do you have to wait until you have reviewed them to cancel them?

Admiral **Miller**. For two reasons, sir, the first reason being, we believe we have already protected the Government's interest by a signed agreement with the university that if we cancel an MOU that it is retroactive to the beginning of this fiscal year.

So, cancelling it today or cancelling it tomorrow has the same effect on their overhead rates.

The second reason is that we have a method of reviewing these Memoranda of Understanding and have expressed our concerns about them to the university, and it is now incumbent upon the university to come back and explain to us why we should not cancel them.

Mr. **Dingell**. No.

It is incumbent upon you to cancel the MOU, whereas if you were to cancel them and then compel the university to come in and explain why that MOU should be reinstituted, either in prior or in changed form, the burden would then clearly be upon the university, rather than upon you and your office.

Isn't that correct?

Admiral **Miller**. The burden is on the university today to explain why the MOU is a valid basis for a continuing business relationship with the Government with regard, in particular, to fiscal year 1991.

Mr. **Dingell**. When, Admiral, did you first become aware of the problems with Stanford?

Admiral **Miller**. I first became aware when the Freedom of Information Act request became public here in Washington, DC., in June. I was officially notified in July 1990.

Mr. **Dingell**. You did not hear anything from Mr. Biddle prior to that time?

Admiral **Miller**. No, sir. I came to this job in June 1990, and I did not hear anything before then.

Mr. **Dingell**. I want you to understand that you are not on the frying pan, but there are some people that just may be, within the sound of my voice.

Were you ever notified by Mr. Dolan or Mr. Simpson that there were any problems here?

Admiral **Miller**. Not before the Freedom of Information Act request came forward. It had actually come forward prior to then.

The Freedom of Information Act request had been submitted by the newspaper, actually, in May, before I was on the scene; and so, these were contemporaneous events.

Mr. **Dingell**. Mr. Simpson, why weren't you making Mr. Dolan and Admiral Miller or Admiral Miller's predecessor aware of these events? You were aware of the fact that there were difficulties here.

You are telling Mr. Biddle that you do not object to what he is saying, but you object to how he is saying it, and you were causing him to recall letters, but you are not communicating with poor Mr. Dolan and Admiral Miller or their predecessors. Why this?

Mr. **Simpson**. I was communicating with my superiors, sir, yes.

Mr. **Dingell**. Well, very well.

Admiral, we thank you.

Mr. Biddle, it is a privilege to meet you. Thank you.

Mr. Dolan, Mr. Simpson, thank you for being before the committee.

Admiral **Miller**. Thank you, sir.

Mr. **Dingell**. The Chair announces that our next panel will be composed of Dr. Donald Kennedy, Ph.D., President of Stanford University, accompanied by Mr. James C. Gaither, President, Board of Trustees, Stanford University; Mr. William T. Keevan, Managing Director, Government Contracts and Consulting Practice, Arthur Andersen; also, Mr. Frank Riddle, Comptroller, Stanford University, and Ms. Janet Sweet, Assistant Comptroller.

Ladies and gentlemen, thank you for being with the committee today.

Mr. **Kennedy**. Mr. Chairman, thank you very much.

Mr. **Dingell**. Mr. Kennedy, the Chair must advise you that there are certain preparatory matters through which we must wade before we can receive your testimony.

First, ladies and gentlemen, for your assistance, to inform you of the rules of the subcommittee, the committee, and the full committees, are copies of those documents there. It is their purpose to inform you both of your rights as you appear here before us, and also to inform you of the limitations on the powers of the committee as it proceeds through its business.

The Chair informs you all that it is the practice and the rules of the subcommittee that all witnesses who testify before the subcommittee testify under oath. Do you or any of you object to testifying under oath today?

Mr. **Kennedy**. No objection, Mr. Chairman.

Mr. **Gaither**. No.

Mr. **Keevan**. No.

Mr. **Dingell**. Very well. The Chair advises you that it is your right to be advised by counsel as you appear here before the committee. Do you, Dr. Kennedy, or any of your associates desire to be advised by counsel as you appear here before us?

Mr. **Kennedy**. Mr. Chairman, Stanford University and I will be represented in these proceedings by Mr. James Fitzpatrick, who is seated over there.

Mr. **Dingell**. Mr. James Fitzpatrick is well known by the subcommittee and much admired by us.

Do you, Mr. Gaither, or you, Mr. Riddle, or you, Mr. Keevan, or you, Ms. Sweet, desire to be advised? Very well. Then if you ladies and gentlemen have no objection, would you please each rise and raise your right hand?

[Witnesses sworn.]

Mr. **Dingell**. Very well. You may each consider yourself to be under oath. The Chair recognizes you now, Dr. Kennedy, for such statement as you choose to give, and we will, upon conclusion thereof, recognize such other of your associates as might desire to be heard an opportunity to present such further statements as they might choose.

Dr. Kennedy.

TESTIMONY OF DONALD KENNEDY, PRESIDENT, STANFORD UNIVERSITY, ACCOMPANIED BY JAMES FITZPATRICK, COUNSEL; FRANK RIDDLE, CONTROLLER; JANET SWEET, ASSISTANT CONTROLLER, COST POLICY AND RECOVERY; JAMES C. GAITHER, PRESIDENT, BOARD OF TRUSTEES; AND WILLIAM T. KEEVAN, MANAGING DIRECTOR, ARTHUR ANDERSEN & CO.

Mr. **Kennedy**. Thank you very much, Mr. Chairman. With me are James Gaither, president of the Board of Trustees at Stanford; on my right, Mr. William Keevan, managing director of the Government Contracts Consulting Practice at Arthur Andersen & Company. He's the senior member of the team now conducting an independent review at Stanford. Frank Riddle, Stanford University controller; and on Mr. Keevan's right, Janet Sweet, assistant controller for Cost Policy and Recovery.

Mr. Chairman, I have submitted written testimony, and I'd appreciate it if you would include it in the record, and with your permission, I'll give you a briefer summary.

Mr. **Dingell**. Without objection, so ordered. The full of your statement will be inserted in the appropriate place, and you are recognized for such summary as you choose to give.

Mr. **Kennedy**. Thank you very much. I want to begin, Mr. Chairman, by affirming Stanford's accountability for the stewardship of public moneys, and my own commitment to be responsive to this inquiry.

Obviously, I'm here because Stanford's cost accounting system has some problems. Some of these result from changing models for the Government's sponsorship of basic research, and thus from Government rules that may no longer match the reality of public expectation. But some of the problems, for which I accept full responsibility, clearly reveal a need for improvements in the procedures and the accounting systems used by Stanford to determine the Government's share of indirect research costs.

Various reviews have revealed deficiencies in our treatment of unallowable expenses, in the monitoring of individual charges that are placed in large cost pools allocated in part to Government-sponsored research and in systems control and documentation. With respect to these, Mr. Chairman, I attempt to be candid in discussing error and constructive in suggesting remedy.

Mr. Chairman, Stanford is one of the world's great universities. It has carried out research as a service to Government without profit and with substantial cost-sharing. It has supported students and their research with its own funds, broadening access to groups of Americans who would otherwise not have it. My deep personal concern for its reputation for quality and integrity established over 100 years guarantees that we will respond aggressively and constructively to the problems recognized in this inquiry.

Mr. Chairman, in the years following World War II, the United States made a momentous decision to convert war-time research efforts into an expanded basic research capacity in the Nation's universities. That relationship began on an assistance model. It has produced wonderful research results, and it has made our system for doing science the envy of the world.

I don't want to tax you with a recitation of its accomplishments, and I want to say in response to a comment you made in your opening statement that, indeed, we recognize that the strong support of you and your colleagues has helped to make it so.

But an important part of the success of university science has been the policy that they are reimbursed for the direct and the indirect costs of the research that the Government supports. Since 1965, the Government formally has followed a policy of reimbursing universities for the full cost of conducting research, and that has helped us to build capacity and to preserve the kind of environment that will be necessary to continue that work into the next generation. So indirect cost policy is an issue that really deserves public attention.

They've come in under increasing scrutiny for at least three reasons: (1) because rates have been rising, and there is some sense, therefore, that they are out of control; and (2) because of concerns on the part of faculty researchers, especially at private universities where the rates are higher. It is an old controversy and one that we are deeply concerned about, but I think it is important not to misunderstand the character of the indirect cost rate increase. With your permission, Mr. Chairman, I'd like to just use two charts, and go to them, if I may.

First, let me point to this cost, which is space related cost. That accounts for 12.8 points out of our last decade in the indirect cost rate increase. Administrative costs account for none; student services and library for only a little.

We are talking about a problem that is related primarily to the construction of new facilities, and one of the reasons that Stanford's indirect cost rate is fairly near the top of a tightly clustered group of institutions is because we have invested more privately-raised funds in new science facilities in the past decade than other universities.

Second, I want to correct a misapprehension. This is a complicated matter, Mr. Chairman, and it is plain that it confuses even such an experienced Agency as the General Accounting Office, which, after having been told several times to the contrary, insists that of every $100,000 paid to Stanford University, $70,000 or $74,000 is added in the form of indirect cost.

In fact, indirect costs are paid not on total direct costs, but on a base called modified total direct costs from which there are numerous exclusions. Over the past 10 years, the proportion of direct costs that have been in the exclusion category has widened, as you see that white band widening, so that the modified total direct cost base has shrunk.

As a consequence, in the year 1990, a typical Stanford University project of $100,000 will not bear $70,000 in additional costs; it will include $33,000 in indirect costs, or, if you want to do it on the addition basis, would add $50,000, and that proportion has not changed since 1980.

That is, because of the shifting base, the actual proportion of its money that the Government sends to Stanford in the form of indirect cost has been constant for a decade.

The rules for determining indirect cost recovery are complex, as I've said, especially in a university setting, where teaching and research take place side by side. How do we allocate indirect costs for one of these functions among the several objectives, in particular instruction and research? I hope you'll permit me to do this by example.

We've heard a lot about the library. How do we decide what proportion of library costs should be allocated to research and to instruction? If you walk into the library and pick up, let's say a copy of The Adventures of Huckleberry Finn in one hand and a volume of The Journal of Neurophysiology in the other, it's fairly easy to guess that The Adventures of Huckleberry Finn is used by undergraduates in course work, whereas the journal is used by advanced graduate students and faculty members largely, though not entirely, in the course of their research.

If we were to go through the library and analyze it book by book for 4 million or so volumes, I think we would agree that the result would, if accurate, be awfully expensive to obtain.

So what one does instead is to agree—that is the Government and the university agree—on sampling methods that examine functions like cataloging and acquisition, that look at numbers of people who use the library and decide, not without debate or difference about the cost accounting itself, that a certain percentage of the library system should be allocated to research. In the case of Stanford, that percentage is 25 percent.

Now, it's possible to go back into the library and pick up the copy of Huckleberry Finn and say, "Gee, this isn't related to research, and the Government shouldn't be paying for any of it," but, of course, the Government should, by that same logic, be paying all of the volume of The Journal of Neurophysiology, and it's only paying 25 percent of that. The concept is one of statistical averaging across the pool, and that is not merely permitted, but mandated by OMB Circular A-21. It is the way the Government tells us to do it.

Now, the pool concept plainly yields an embarrassing result in connection with the operating accounts of Lou Henry Hoover House, the university-owned building that has housed five Stanford presidents, and is also a facility for hosting meetings and receptions and academic conferences.

Some of the activities that take place at Hoover House are related to research; many are not. The costs of operating the house are charged to a cost group called General and Administration, of which 23 percent is allocated to Government-sponsored research.

Just as in the case of the Library, some of these expenditures relate almost totally to research and others relate not at all. Many items which outside experts tell us are legally allowable, like the flowers, the furniture purchase or repair, even some charges related to the personal lives of the President and his family, have appeared in particular accounts included in this pool.

These expenditures were evaluated individually for whether they were appropriate as university expenditures and therefore allowable in the pool. Even though they're lawfully included, I don't think we should hesitate to throw out charges that don't seem right and that is why we have done that and why we're going to insist in the future on an up-front review of appropriateness in these sensitive areas.

I want to mention just one or two other problems, Mr. Chairman, in passing, because much testimony has been given about the Inspector General's Report with respect to Mr. Biddle's charges about coziness. I certainly won't dwell on that. We certainly did not take complete comfort in the IG Report. My own remarks were limited to my very considerable pleasure that there were not, in fact, substantiations of the charges of coziness. As to the Memoranda of Understanding, I hope we can all understand that these are written agreements between Stanford and the Government.

They are under review now. They will all be reviewed between us and the team that Admiral Miller has appointed to represent ONR, and they may be modified, and perhaps some of them should be. As to their status as contracts, I want to simply state that it is Stanford's view that they are contracts, and we've submitted an opinion from our legal counsel to that effect, and I'd appreciate it if that could be included in the record, as well, Mr. Wyden.

Mr. **Wyden** [presiding]. Without objection, that will be received by the subcommittee.

Mr. **Kennedy**. Thank you very much. Mr. Chairman, we have a problem and we're taking it seriously. Several weeks ago, I announced a three-point initiative to evaluate and to strengthen Stanford's accountability for taxpayer dollars. First, we engaged Arthur Andersen and Company to conduct an independent assessment of our accounting system and procedures and to recommend appropriate changes.

Second, we've appointed a five-member advisory board with extensive experience in Government, in research, in accounting and management to review the conclusions that the Arthur Andersen team reaches and to advise me on the implementation of improvements to Stanford's accounting system and on other matters related to accountability for federally sponsored research at Stanford.

Members of the panel, all of whom have agreed to serve without compensation are Joseph Conner, chairman of Price Waterhouse World, Dr. Timothy Healy, President of the New York Public Library, Admiral Bobby R. Inman, USN, Retired; Paul O'Neill, CEO of Alcoa and Dr. Maxine Singer, the President of the Carnegie Institution of Washington.

Third, we have voluntarily withdrawn, as I mentioned, cost claims submitted for the operation of Hoover House and two other University residences for all the fiscal years since 1981. These costs total over $500,000.

In addition, I think we need a fourth initiative. We are at least as disturbed as you are that the Government has not been able to close out a number of open audit years at Stanford. ONR may not have asked them to audit as frequently as one would have liked, but we have asked them to audit first in 1984, and despite these longstanding requests, adequate auditing has not been provided until this subcommittee displayed its interest in getting more activity. Until those years are closed, the allegations that have received so much public attention will continue to hang over us, and we don't like that.

We've attempted in good faith to operate under a complex set of rules and we believe that when the facts are fully established, we'll be vindicated, both legally and as to our intent. We believe that the record will show that legally allowable items like the ones that have been withdrawn and charges resulting from human error, add up to a small fraction of the numbers that have been bandied about by Mr. Biddle and others, and that, as the Inspector General noted, the Government's interests are protected in the audit process.

I would urge the members of the subcommittee and its chairman to insist that the Government focus adequate resources on this job and to establish a strict deadline for completion of these audits. Everyone's interests will be served by establishing the facts and quantifying the concerns that have been raised.

Clearly, significant changes are being made at Stanford so that the rules governing indirect cost recovery are better implemented. Indeed, universities could even be required to develop the kinds of accounting systems demanded of for-profit Government contractors. That's an appropriate policy issue to address, but I think one needs to recognize that such systems will be extremely costly to the Government and to us, may well drive indirect cost rates up, and will not, in any event, address the real engine behind the rise in indirect cost rates, namely, the need of universities across the country to build and modernize research facilities that are essential to doing really modern research in almost all disciplines.

As this hearing suggests, universities can expect to be held to a higher standard of accountability than we have in the past, and we're ready to meet that standard. I trust that in addressing legitimate concerns, the Government will preserve a national research system of excellence and that can be only done by paying for the legitimate and fair direct and indirect costs of conducting that research.

Our objective—and I know this concerns you particularly, Mr. Wyden, and I'm glad you're in the Chair—is to turn this challenge into an opportunity and to make Stanford a model for close accountability of public funds. We've got a great scientific enterprise. No other industrial Nation places two-thirds of all fundamental research in the places where the next generation of scientists is being trained.

At Stanford, it's functioning superbly to advance the frontiers of knowledge. We can all be proud of that, but at the same time, we must be grateful to a society that has been successful enough and generous enough to permit some of us to visit the unknown, both to satisfy our human curiosity and to bring back something of value. It's a privilege and those of us who enjoy it should be fully accountable to those who sponsor it and Stanford will fulfill its obligation. Thank you very much.

[Testimony resumes on p. 166.]

[The prepared statement of Dr. Kennedy follows:]

STATEMENT OF DONALD KENNEDY
PRESIDENT, STANFORD UNIVERSITY

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

HOUSE COMMITTEE ON ENERGY AND COMMERCE
102nd CONGRESS, FIRST SESSION

MARCH 13, 1991

Mr. Chairman and Members of the Subcommittee:

My name is Donald Kennedy, and I am the President of Stanford University.

I want to begin today by affirming Stanford's accountability for the stewardship of public monies, and my own commitment to be responsive to this Subcommittee's inquiry. I am here, obviously, because Stanford's cost accounting system has some problems. Some of these, I believe, emerge from shifts in the government's concept of how it should sponsor basic research in universities and from government accounting rules that may no longer match the reality of public expectations. But some of these problems — for which I accept full responsibility — clearly reveal the need for improvements in the procedures and the accounting systems used by Stanford to determine the government's share of indirect research costs.

For example, various reviews have revealed shortcomings in our treatment of unallowable expenses, in the monitoring of individual charges that are placed in large cost pools allocated in part to government sponsored research, and in system controls and documentation. With respect to these, I intend to be candid in discussing error and constructive in suggesting remedy.

Proper accountability for the expenditure of federal funds is essential to demonstrate that taxpayer dollars are being spent wisely and to maintain public confidence in the university-based research effort. Stanford takes this obligation very seriously. We are committed to making improvements so that the problems that have been identified will not recur, and we are taking aggressive remedial action that I will describe later.

Importance of Research

Before I turn to issues that relate specifically to Stanford, I think it will be useful to present a more general view of the development of our nation's system of supporting basic research, how it works, and why it has been so successful.

After World War II, the United States made the momentous decision to convert its wartime research efforts into a greatly expanded basic research program located in our universities, where the training of the next generation of scientists takes place. Originally, federal support of basic research in universities developed along the lines of an "assistance model"; academic scientists wanted to work on fundamental problems and the government (in the first instance, the Office of Naval Research) wanted to get it done. The enterprise grew both in size and in success, and it became a vehicle of great scientific achievement.

The universities that had come to be the home to this venture began to invest heavily in infrastructure; but unlike defense contractors whose accounting systems have been created for the sole purpose of complying with federal record keeping requirements in their manufacturing activities, universities have not made massive investments in accounting systems. Up until now, both the government and universities believed that the taxpayer's money was better spent on research than on layers of accounting and legal controls to oversee that research. It may be that both the government and universities need to rethink that view.

The partnership between the universities and the federal government has been spectacularly successful, giving the United States an unquestioned preeminence in basic scientific research and higher education. This is a system that other countries envy in its success and are seeking to emulate.

Federal support for university research has made possible an extraordinarily broad array of valuable and important programs in a variety of fields — from microbiology to engineering, from particle physics to medical genetics. At Stanford, federal research support has played a critical role in stunning advances, including such noninvasive medical technologies as magnetic resonance imaging; the discovery of the first reliable cure for Hodgkin's disease; the development of the microwave transmitter that led to the first modern radar systems; the unlocking of the smallest known physical particles in the universe at the Stanford Linear Accelerator; the development of an experimental mouse with a human immune system that holds great promise for AIDS and other types of medical research; and a series of basic discoveries essential to modern genetic engineering. Indeed, just last month there was a successful clinical trial of a genetically engineered protein developed by scientists from Stanford and the University of California at San Diego. The protein combats the bacterial endotoxins that produce septic shock, a serious consequence of infection responsible for tens of thousands of deaths each year.

What Indirect Costs Are and Why They Are Important

Underlying all this, and essential to its success, has been the government's policy of reimbursing universities for both the direct and indirect costs of the research it has supported. Direct costs are those expenses like technicians' salaries, equipment and materials that can be associated with specific research projects; indirect costs are expenses like utilities, administrative expenses, building and grounds maintenance, and buildings that are essential to research, but cannot easily be associated with a specific project. Indirect costs support the physical and administrative infrastructure necessary to conduct research. And as in many other sectors of American society, the physical infrastructure of universities is aging and needs to be replaced or updated to accommodate modern research. Since 1965 the government formally has followed a policy of reimbursing universities for their full costs of conducting research, and it is this support that has enabled universities to build their research capacity and to conserve the kind of environment needed to guarantee continued scientific progress.[1] Without receiving reimbursement for indirect costs, Stanford and other universities simply could not afford to do the research the government wants done. So indirect cost policy is a scientific issue of great moment, and it deserves public attention.

Why Indirect Cost Rates Vary and Why They Are the Subject of Controversy

The rules that govern indirect cost recovery, developed and modified over the years and codified in a document called Office of Management and Budget Circular A-21, require that indirect costs be shared proportionately among those purposes, called "cost objectives," that benefit from indirect expenditures. To determine the share of indirect costs that should be allocated to federally sponsored research and then reimbursed by the government, the OMB provides that universities may conduct special cost allocation studies and apply charges proportionately. As is recommended by the applicable government guidelines, these cost studies have been codified in written agreements with the government, which at Stanford are called Memoranda of Understanding, or MoUs.[2] In the absence of such a study or other cost allocation method, universities can apportion the costs using a set of less-preferred "default" formulas. The rules then require that the portion of indirect costs allocated to the government be expressed as a rate which is applied to a base that is a subset of total direct costs, known as Modified Total Direct Cost (MTDC). That rate is then applied to this base of each research project to distribute the indirect costs to that project.

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[1] Although the government has formally followed a policy of "full cost recovery," in practice universities receive less than their full actual costs of conducting research. This is because certain government grants, like Young Presidential Investigator Awards from the National Science Foundation, simply do not reimburse indirect costs and require significant cost-sharing on the part of universities. Stanford voluntarily forgoes many items of costs through waivers and agreements with the government. In addition, the rules make many items of cost specifically unallowable.

Indirect costs, which have been the subject of controversy for some time, have come under increasing scrutiny for a number of reasons. First, because rates have been rising, there is a concern that the system is in some sense "out of control." Second, there is increasing dissatisfaction on the part of faculty researchers, especially those at private universities where the rates are highest. These feelings are in part born of the fear that programs and projects may become less "competitive" with respect to those at other institutions, particularly state universities, where recovery is typically lower. We have held extensive discussion with the Stanford faculty on these matters and are very sympathetic to their concerns. Third, Congressional and sponsoring agencies interest in the indirect cost issue has risen as faculty discontent is voiced and as limits on discretionary domestic spending are tightened. In a climate of constrained resources, all of us have a special responsibility to insure that money is being spent wisely and frugally.

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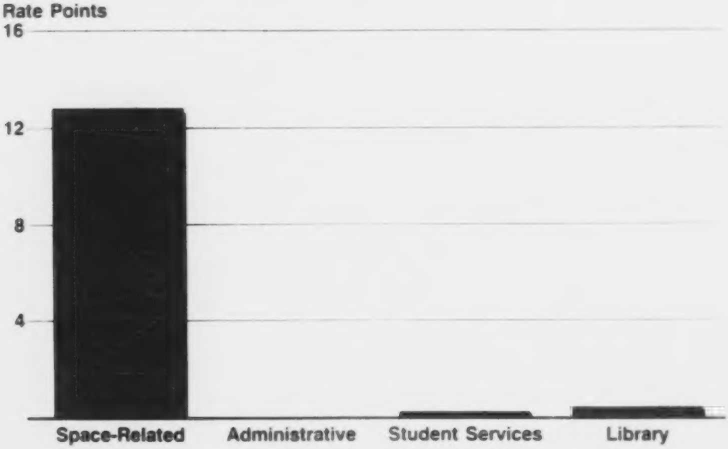
[2] OMB Circular A-21, Section A.2 provides that the "successful application of these cost accounting principles requires development of mutual understanding" between the universities and the government. MoUs are written agreements of such mutual understandings between Stanford and the government.

It is important, however, not to misunderstand the character of this indirect cost rate increase.

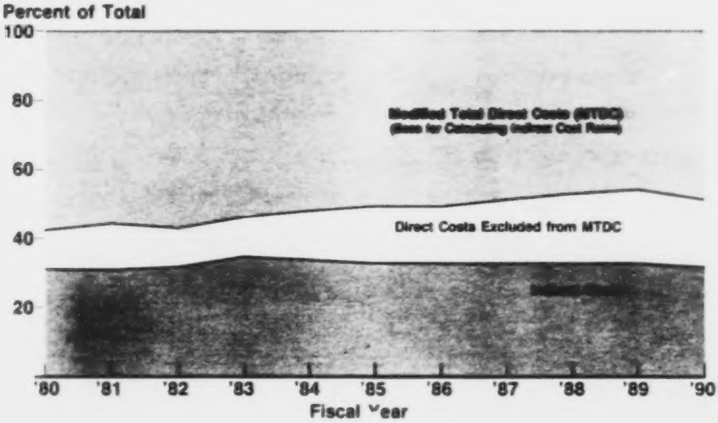
- First, it is largely associated with facilities — new buildings and other space-related costs. For instance, Stanford's indirect cost rate has risen 13.4 points over the decade — with 12.8 points of that increase due to space-related costs. Administrative costs have remained virtually flat over the decade. The following chart illustrates these points:



Stanford University
Increases in Indirect Cost Rate by Component, FY1981 - FY1990

- Second, unlike commercial contractors, universities do not recover indirect costs on all of their direct costs; instead, their indirect cost rates are calculated on Modified Total Direct Cost — which has been proportionately declining over the last decade as a result of the changing nature of research. As a result, even though Stanford's indirect cost rate is 70 percent, the actual fraction of government research dollars that come to Stanford as indirect costs is about one-third of total research support, and that fraction has remained constant over the past decade. The chart below illustrates this point:

Stanford University
Federal Direct and Indirect Cost Components as a Percentage of Total Federal Research Contracts and Grants, FY1980 - FY1990



I should also note that universities already have much lower indirect cost rates and charge the government less for doing research than commercial contractors. For instance, universities do not charge a fee or profit to the government, their faculty members donate much of their time spent on government projects, and the salaries charged for research assistants (graduate and post-doctoral students) are much less than salaries in private industry for similarly qualified personnel.

- Third, there are good reasons why different kinds of institutions have different rates. Universities vary widely in terms of the kinds of research they conduct, the age of their facilities and whether they are supported by state tax revenues. Also, changes in the 1986 tax bill denied some private institutions access to tax-exempt financing for facilities construction, making capital more expensive for these schools. In addition, the same expense recovered by one institution as an indirect cost may be charged by another as a direct cost, or collected through the staff benefits pool. So different rates are to be expected, and the rules governing indirect cost recovery permit different approaches to determining the indirect costs of doing research and recovering them.

Use of Cost Pools in Allocating Expenses

The rules for determining institutions' indirect cost recovery are complex, especially so in a university setting where teaching and research take place side-by-side. For example, Stanford libraries would surely exist if Stanford did no government sponsored research; but they are much larger and more costly because we do research as well as instruction. How do we figure out how library costs should be divided between these activities? Stanford, like many other institutions, has for decades calculated costs by creating pools of costs associated with a particular cost category, like the library. Within each cost category, there may be subgroups of costs. We then decide how much of each cost group is associated with research and how much is associated with other activities, mainly instruction. Then a single percentage is applied to each cost group to determine the portion to be charged to sponsored research. Let me emphasize that the use of cost pools and cost groupings is specifically required by the government in OMB Circular A-21.

I would like to illustrate how the pool process works. Take two library books: *The Adventures of Huckleberry Finn* and Volume IX of the *Journal of Neurophysiology*. The first is used almost entirely by undergraduates, the second by scientists — advanced graduate students or faculty — in ways that relate to their sponsored research. Instead of using a pool of costs, we could allocate directly the costs of acquiring, cataloging and maintaining these two books, by examining who checked each one out and watching who used them, how they were used and what they were used for. If we did this for each of several million books in the libraries, we could add the results and determine how much of the libraries' costs should be paid for by government sponsored research.

Of course, it would be highly inefficient — and extremely costly — to do it that way. To save expense to the taxpayer and avoid extra paperwork, universities and the government have agreed to do selected surveys and studies. The results are put together to yield a solid estimate of how much of the library costs is associated with instruction and how much with sponsored research. The result is both economical and fair, but it opens the door to questions because the allocation to government-sponsored research (25 percent for the Stanford libraries) is an average. Thus, one can pick up *Huckleberry Finn* and ask: "Do you mean to tell me the taxpayers are paying 25 percent of the cost of this book, even though it is obviously not used for government sponsored research?" But on the other hand, the government is paying only 25 percent of the cost of a learned journal used almost entirely for research.

Stanford has attempted to live by rules established by the government, but also to recover the amount of reimbursement to which the university is entitled under those rules. Indeed, as a public trust, it is our responsibility to the other stakeholders in our institution — students, donors, and significantly, the students and researchers who will come through our doors in the future — to collect the reimbursement to which we are entitled so as to keep the institution fiscally sound over time. The alternative would be to charge parents and students more for tuition and fees because we have failed to recover the costs we have incurred by conducting sponsored research, hardly a fair or desirable outcome.

So why do we find ourselves the focus of so much negative attention?

Stanford's Situation

For the past six months or so our university has been the subject of an unparalleled level of government auditing activity, sparked in large part by the general policy concerns I've described, as well as by a series of extremely serious allegations made by Paul Biddle, the Resident Representative of the Office of Naval Research (ONR) assigned to Stanford. We find ourselves a testing ground for what is a major issue in science policy, an issue that is of such crucial importance that it could very well affect the future health of the entire American scientific enterprise. The outcome of this hearing could well have a substantial impact on the ability of the scientific community to sustain the success achieved by these policies. We are as determined as you are, Mr. Chairman, to deal with these issues fairly and constructively.

What has this scrutiny shown us so far?

Let me start by dealing with Mr. Biddle's concerns. During the past year, he has leveled a series of allegations relating to federally sponsored research at Stanford. His two main specific contentions were that we had overcharged the government by as much as $200 million in indirect costs over the past decade and that his predecessors and superiors at the ONR had what he called a "cozy" relationship with Stanford that benefited the university at the expense of the taxpayer.

After investigating these allegations for nearly six months, the ONR Inspector General said that the amounts Mr. Biddle alleged as overpayment by the government were "speculative, based in part on incorrect assumptions and calculations, and also included subjective judgments." Further, in relation to the "coziness" charge, the Inspector General found "no apparent partiality."

But the Inspector General also found that the potential for overpayment did exist. And the truth is that this inquiry has brought to light some very uncomfortable realities for Stanford.

Stanford's Specific Problems

For one thing, Stanford has many so-called "open" years for which audits conducted by the Defense Contract Audit Agency (DCAA) have not been concluded and the rates finalized. While ONR requested such audits and we expressed our concern that such audits had not been conducted to close out past years, we understand that DCAA lacked sufficient staff to conduct them. That means that we have more than 25 million separate transactions that are subject to review by the government.

Not too surprisingly, in the course of logging in the nearly three million transactions that go through the 17,000 accounts in our system each year, we have also found we made some mistakes. In one case, we learned that a yacht and other equipment donated to the Athletic Department's sailing program had been incorrectly accounted for as capital equipment for academic programs and were thus put into a category of costs that is depreciated, with a portion of that depreciation charged as an indirect cost to the government. That was a flat-out mistake, and it has been rectified.

Our own review and those of government agencies have also raised concerns with otherwise allowable costs within cost pools, which I described earlier, in certain accounts. The most publicized specific items involved are in the operating accounts of the Lou Henry Hoover House, the university-owned building that has housed five Stanford presidents and also is a facility for hosting meetings, receptions and academic conferences. Some of the activities at Hoover House are related to sponsored research, and thus government rules allow a portion of the cost of operating and maintaining the house to be charged to research activities, including government sponsored research. The costs of all Hoover House activities are included in a cost group called General Administration, of which about 23 percent is allocated to government-sponsored research.

As in the case of the libraries, some of these expenditures relate almost wholly to research, while others relate not at all. The trouble is that all appropriate university expenses for the operation of Hoover House were placed in cost pools, without a separate review of each individual item to determine whether it should have been included in a pool which is charged in part to the government. Many items, which outside experts tell me are legally allowable — flowers, furniture purchase or repair, even some charges related to the personal living quarters of the President and his family — have appeared in particular accounts included in this pool.

These expenditures were evaluated individually for their appropriateness as university expenditures, but not separately evaluated individually for their appropriateness as government-reimbursable expenditures. Our working assumption has been that such items found to be appropriate university expenditures would also be appropriate for government cost accounting purposes.

Indeed, that approach is based on fundamental government contracting principles; the starting point for determining the reasonableness of a particular expense charged to the government is whether it is an ordinary and necessary expenditure for the government contractor. Nevertheless, we are now faced with a more basic question: how should we handle costs that are perfectly appropriate as university expenditures and lawful under the government rules but which we might all agree should not be included in a pool of costs that is charged even in part to the taxpayer?

Currently, legitimate university expenditures are included in large pools of costs without transaction-by-transaction review for appropriateness as government expenditures. I should have been more alert to the serious policy issue raised by our cost accounting practices and insisted on more intensive review of these transactions. As you will see, we are taking determined steps to correct the problem so that it will not recur. Moreover, the independent review by Arthur Andersen now underway will be examining how we handle these "high risk" accounts, and Arthur Andersen will make recommendations as necessary to preclude the occurrence of these problems in the future.

There has also been much attention paid to a so-called "wedding" reception hosted by the Board of Trustees that was paid for out of the Board's account, which is also part of the General Administration cost group. The facts are quite different from what has been reported. Neither the federal government nor the Board of Trustees paid any part of my wedding reception. Our wedding reception took place immediately after the wedding, was held off-campus at a Palo Alto hotel, and was attended by family and friends. I wrote a check for that myself. On December 6th, some nine days after our marriage, the Board did host a welcoming reception for my wife to introduce her officially to the Stanford community. This expenditure was evaluated as a perfectly appropriate university expenditure, but like the others listed above, was not specifically reviewed for its appropriateness as a government expenditure. I determined that, regardless of its legality, no portion of the cost of that reception should have been charged to the taxpayer, and I have directed that it be withdrawn.

Finally, Stanford recently discovered that the cost of two meals before the wedding were inadvertently included as a university expense in a cost pool. Those costs, which were included in the Hoover House account, were withdrawn in January.

Mr. Chairman, we have a problem, and we are taking it seriously. Seven weeks ago I announced a three-point initiative to evaluate and strengthen Stanford's accountability for taxpayer dollars. First, we engaged Arthur Andersen & Co. to conduct an independent assessment of our accounting system and procedures and to recommend appropriate changes. Second, we have appointed a five-member Advisory Panel with extensive experience in government, education, research, management and accounting to review the conclusions of Arthur Andersen and to advise me on the implementation of improvements to Stanford's accounting system and on other matters related to accountability for federally sponsored research at Stanford. Members of the Panel, all of whom serve without compensation, are: Joseph Connor, Chairman of Price Waterhouse World Firm; Dr. Timothy S. Healy, President of the New York Public Library; Admiral Bobby R. Inman, USN, (Ret.); Paul O'Neill, Chairman and CEO of Alcoa; and Dr. Maxine Singer, President of the Carnegie Institution of Washington. Members of the Panel were briefed at a meeting this week by the senior member of the Arthur Andersen team; he reviewed both the team's work plan and its progress to date. Third, we have voluntarily withdrawn cost claims submitted for the operations accounts of Hoover House and two other university residences for the fiscal years since 1981. These costs total over $500,000.

Two Additional Issues

There are two additional issues which I want to discuss — the charge that Stanford has relied too extensively on Memoranda of Understanding, or MoUs and the charge that Stanford has not been sufficiently forthcoming in its response to the requests from an array of government auditors who are examining Stanford's accounting system.

Memoranda of Understanding

There has been wide attention from the press and others about Stanford's use of Memoranda of Understanding in accounting for our indirect costs. As I mentioned earlier, Memoranda of Understanding are nothing more than written agreements, negotiated and signed by both Stanford and the government, that spell out how both parties will interpret and implement, among other matters, indirect cost accounting guidelines. There is nothing exotic, suspicious, or for that matter, "cozy," in doing this; indeed, as we have noted, A-21 "requires development of mutual understanding" between the government and universities for the "successful application of these cost accounting principles." Reaching a sound, clearly understood agreement at the outset as to how costs will be determined and allocated is solid business practice; it is particularly important given the complicated nature of cost accounting issues and the fact that A-21 permits universities to use various methods to accommodate their unique circumstances and structures. Stanford has about 85 of these agreements that are currently active, many of which are just a few sentences long. They deal with a broad variety of issues, from the definition of specific terms, to fundamental issues of how the costs of Stanford's libraries will be accounted for, to items as specific as who, in the event of the death of a particular faculty member, has the authority to sign reports for a specific research grant. In 1979 when the OMB guidelines for government research underwent significant changes, both the Navy negotiator and Stanford officials agreed it would be prudent to lay out specifically, openly, and in writing, the terms upon which both parties would act.

We believe these MoUs are binding agreements, negotiated in good faith, to protect the interests of both parties. Two legal opinions from our counsel, Arnold and Porter, confirm that the MoUs are an appropriate method to establish binding agreements on the recovery of costs at Stanford. The opinions also find that the governmental challenges to the MoUs, based on the asserted failure of a Navy official to follow the Navy's internal procedures, do not alter their opinion as to the MoUs' binding nature. These opinions have been furnished to the Subcommittee.

Nevertheless, Mr. Chairman, Stanford and the ONR Special Team have agreed to a formal review of each MoU. That review is now underway and is expected to be completed in April.

Stanford's Cooperation in Investigations

The second issue I would like to address is Stanford's willingness to cooperate in this investigation. I want to assure you, Mr. Chairman, that we have tried to be as responsive as we know how and have mobilized the resources we have to respond to this Subcommittee and to the various simultaneous government reviews and audits that have been in progress since last August.

But I must tell you, Mr. Chairman, that the ability of various government officials to request information far exceeds our ability to provide it as quickly as we would like. Let me give you a notion of what we are facing. As of last week we had received 3,752 requests for information in the last five months. These range from a list of thousands of pieces of equipment at the university to an explanation of what a dishwasher is for. We have produced for the government over 22,000 pages of documents. As you know, we have received requests from the Subcommittee. In addition, there are 22 auditors from DCAA, five from GAO, and five from the ONR Special Team currently requesting data. (In contrast, we typically have three or four government auditors in any given period going over our books.) We have hired additional staff and consultants and put in place special systems to try to keep up with the workflow. We hope that this committee understands that Stanford has been responsive to the unprecedented demands of government auditors.

Summary

Clearly, Mr. Chairman, significant changes are being made at Stanford so that the rules governing indirect cost recovery are better implemented. Even more broadly, the rules could be changed to require universities to develop the kinds of accounting systems required of for-profit government contractors. That is an appropriate policy issue to address. But indeed, such systems can be extremely costly and are in fact likely to drive indirect cost rates up. In any event, accounting changes will not address the real engine behind the rise in indirect cost rates: the need of universities across the country to build, modernize and maintain research facilities that are now essential in conducting cutting-edge research in almost all disciplines.

As this hearing suggests, universities can expect to be held to a higher standard of accountability than we have in the past. I trust, though, that in addressing legitimate concerns about indirect costs, policymakers take care to preserve a vital national research system of excellence: that can only be done by paying for the legitimate and fair direct and indirect costs of conducting that research.

Our objective is to turn this challenge to our own indirect cost recovery into an opportunity and make Stanford a model for university contracting relationships with the government. America has a great scientific enterprise. No other industrial nation places two-thirds of all fundamental research in the places where the next generation of scientists is being trained. Our system has become the envy of the world. At Stanford it is functioning superbly to advance the frontiers of knowledge.

We can be proud of all that. But at the same time, we must be grateful to a society that has been successful enough and generous enough to permit some of us to visit the unknown — both to satisfy our human curiosity and to bring back something of value. It is a privilege, and those of us who enjoy it should be fully accountable to those who sponsor it. Stanford will fulfill that obligation.

Thank you.

Mr. WYDEN. Thank you, Doctor. Do any of your associates desire to make an opening statement at this time?

Mr. KENNEDY. With your permission, Mr. Wyden, Mr. Keevan and Mr. Gaither both have rather brief statements; thank you.

Mr. WYDEN. Without objection, we'll have those statements at this time. We will begin with you, Mr. Keevan, and then you, Mr. Gaither.

TESTIMONY OF WILLIAM T. KEEVAN

Mr. KEEVAN. Good afternoon, Mr. Chairman. My name is William T. Keevan, and I'm a partner in Arthur Andersen and Company and I'm the Managing Director of the firm's Government Contracts Consulting Practice. I'm also the Engagement Partner on Arthur Andersen's special review of the university's Government contracting accounting systems and controls.

I have submitted a written statement and I'd like to summarize that for you. Our review entails a comprehensive study of Stanford's systems and controls for the accumulation, classification, allocation and billing of costs under applicable statutory and regulatory requirements.

We're assessing the adequacy of these controls and will develop recommendations to implement any required improvements. Our review is focusing on the future, rather than on the past to assist President Kennedy in his goal of making Stanford a model for the use of and accountability of funds of a research institution. I'd stress, however, that no system of controls will prevent all mistakes from occurring.

We're coordinating our activities with DCAA and will share the results of our review with DCAA and other Government agencies having oversight authority at Stanford. We expect to complete the review in the summer of 1991. Our review is still in process, but I'd like to comment on some of our preliminary observations and conclusions regarding Stanford's control procedure.

In this regard, we're only addressing Stanford's systems and controls for compliance with the specialized accounting requirements for Government contracts and grants. No questions have been raised about the reliability or acceptability of the university's overall accounting system for financial reporting purposes. However, although satisfactory for general university purposes, Stanford's systems and controls may fall short of satisfying some of the specialized requirements of Government research contracts and grants.

To date, we've identified several areas that may require improvement. The first area of concern is the manner in which Stanford addresses the matter of unallowable indirect costs. Stanford's current systems do not track and eliminate individual unallowable items to the same extent as the accounting systems used by most defense contractors. For example, to exclude unallowable entertainment expenses, Stanford and the Government formally agreed to deduct 20 percent from certain accounts in indirect cost pools.

While this approach may be appropriate in some cases, it does not provide certainty that all unallowable costs have been identified, nor does it provide a detailed audit trail. Our initial review has identified other areas of general inquiry where Stanford's existing controls may require strengthening.

These include the adequacy of training given to Stanford employees on the requirements of applicable regulations; the scope of the Internal Audit Department's responsibility for monitoring compliance with applicable regulation; the adequacy of the university's formal written policies and procedures in areas relevant to the current inquiries, and the structure of the current accounting system which may contribute to the risk of non-compliance with applicable regulation. When we complete our review, we will report our recommendations for improvement.

Now I would like to turn to some other matters.

As you know, Memoranda of Understanding, MOU's, between Stanford and the Government have recently been the subject of much discussion. Circular A-21 requires development of mutual understanding between universities and the Government as to the scope and interpretation of cost accounting principles.

The fact that Stanford has a relatively large number of these agreements does not mean that the agreements were in any way inappropriate. Indeed, some of these, such as agreements simplifying Stanford's calculation and allocation of equipment depreciation, were intended to save both Stanford and the Government money. As it now appears that this agreement is no longer acceptable to the Government, Stanford is taking steps to implement a system to determine depreciation on an item-by-item basis. The costs of developing this system will be appropriately included in Stanford's indirect costs allocable to Government contracts.

Now we understand that Stanford has been quoted a price of approximately $800,000 to put such a system in place, and roughly an additional $300,000 per year over and above what it currently spends to maintain this system.

A second matter involves some apparent public confusion surrounding the nature of Stanford's indirect costs and which of those costs can be properly charged to the Government. As a general matter, indirect costs are costs which are applicable to more than one university activity. Under applicable regulations, the university is allowed to recover all of its allowable and reasonable indirect costs which are allocable to Government research.

A key test for reasonableness of costs, such as linens and flowers charged to the president's house, is whether those costs are prudent and necessary for the overall operation of the university, despite the fact that they have no direct relationship to research. Now we understand that Stanford's board of trustees has confirmed that these types of costs meet these criteria from the university's perspective.

A third matter I would like to highlight involves some factors that must be taken into consideration for any accurate assessment of the costs of sponsored research at Stanford. First, Stanford charges no fee or profit to the Government in contract with commercial companies performing research.

Further, by combining teaching and research, Stanford is able to staff Government projects with research assistants, graduates and post-graduate students at a fraction of the labor cost for comparably trained personnel in commercial organizations. In conclusion, I want to reiterate the cost allowability issues frequently are not clear-cut questions. Competing issues of reasonableness, necessity and benefit must be addressed.

Clearly, educational institutions could adopt the costly accounting systems and controls and practices employed by dedicated defense contractors. Such a standard would enable both Stanford and the Government to greatly reduce transactions that have received so much attention lately.

The question is whether this is a necessary means to achieve reasonable assurance that the Government is getting its money's worth. I recognize this as a legitimate area of policy debate, as to whether it is in the Government's best interests to incur added costs necessary to achieve these greater levels of certainty.

As we continue our review, we hope that the results of our efforts will help Stanford meet its stated objective of improving its accountability as a steward for taxpayers' funds.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Keevan follows:]

PREPARED STATEMENT
OF
WILLIAM T. KEEVAN
ARTHUR ANDERSEN & CO.

Mr. Chairman and Members:

My name is William T. Keevan. I am a partner in Arthur Andersen & Co., and Managing Director of our Government Contracts Consulting Practice. In addition to coordinating this aspect of the firm's practice, I have been active within the accounting profession in matters related to cost accounting, self-governance, regulatory compliance and other areas of particular interest to government contractors.

I recently completed a three-year term as the first chairman of the Defense Contractors Committee of the American Institute of Certified Public Accountants (AICPA), and remain an active member of the committee, including serving as its liaison to the Cost Accounting Standards Board. I am the principal author of the chapter on auditing of the AICPA Audit and Accounting Guide, Audits of Federal Government Contractors, which was prepared by a special AICPA committee. Additionally, I directed Arthur Andersen & Co.'s Study of Government Audit and Other Oversight Activities Relating to Defense Contractors, which was conducted for the Packard Commission.

Founded in 1913, Arthur Andersen & Co. provides audit and business advisory services, tax services and specialty consulting services. We are part of the Arthur Andersen Worldwide Organization, an international professional partnership employing more than 56,000 people at 299 offices in 66 countries.

Stanford University's President Kennedy and Board of Trustees have asked me to report to you today about the status of Arthur Andersen & Co.'s special review of certain of the University's accounting systems and controls. I am Arthur Andersen & Co.'s engagement partner on that review. We were retained in January to assist Stanford in re-examining its accounting and indirect cost systems as those systems relate to federally sponsored research.

Our review entails a comprehensive study of Stanford's accounting systems and controls related to the accumulation, classification, allocation and billing of costs under federal government contracts and grants. We are assessing the adequacy of these controls and will develop recommendations to implement any required improvements. Our review is focusing on the future rather than the past to assist President Kennedy in his stated goal of making Stanford "a model for the use of and accountability for funds by a research university."

Arthur Andersen & Co. has extensive experience in conducting compliance systems reviews for government contractors. We have worked jointly and effectively with the Defense Contract Audit Agency ("DCAA") in the past, we have consulted with the General Accounting Office on defense contractor related matters and we were engaged by the Packard Commission in connection with its study of Defense Management.

I. Arthur Andersen's Review Procedures For Stanford

Our review has been designed to assess the adequacy of control procedures related to Stanford's business and accounting practices against "control objectives"; these objectives include compliance with the requirements imposed by OMB Circular A-21, "Cost Principles for Educational Institutions," and other statutory and regulatory requirements. Following our review, we will recommend improvements required to provide reasonable assurance that the stated control objectives are met.

The term "reasonable assurance" is one of art. No system of controls will prevent all mistakes from occurring. Instead, the goal is to minimize the risk that material errors or deficiencies will occur and escape detection. The concept of reasonable assurance recognizes that the costs of a control should not exceed the benefits of the control.

The following briefly summarizes our approach to this review:

1. First, interviews are being held with appropriate Stanford personnel to obtain an understanding of transaction flows and to identify key controls and procedures.

2. Second, flowcharts are being developed to document our understanding of the transaction flows and to confirm our understanding of key controls and procedures.

3. Third, we will assess the adequacy of existing controls in light of the defined control objectives.

4. Fourth, we will test selected transactions to confirm that existing controls are operating as intended.

5. Finally, strengths and weaknesses in controls will be identified and recommendations for improvements will be made. In some cases, these recommendations will include implementation of new controls. In other cases, the recommendations will focus on methods to make the existing controls more effective.

We are coordinating our controls review activities with the DCAA. To date, we have held several joint Arthur Andersen and DCAA briefings. Furthermore, we intend to share the results of our review and our conclusions with DCAA and other government agencies with oversight authority at Stanford. We expect to complete this review in the summer of 1991.

II. Initial Observations Concerning Stanford's Control Procedures

While our review is still in process, I would like to comment on some of our general observations and preliminary conclusions regarding Stanford's control procedures.

At the outset, I should note that we are here only to address Stanford's systems and controls for compliance with specialized accounting requirements for government contracts and grants. No question has been raised about the reliability or acceptability of the University's overall accounting system for financial reporting purposes. Stanford's financial statements are the subject of regular audit and report by Stanford's outside auditors, who have found that those statements are presented fairly and in conformity with generally accepted accounting principles for financial reporting purposes.

However, although satisfactory for general university purposes, Stanford's accounting systems and controls may fall short of satisfying some of the specialized requirements of government research contracts and grants. This is due to the complexity of the rules and regulations which are applicable to the performance of government contracts. To date, we have identified several areas in Stanford's control procedures that may require improvement.

The first area of concern is the manner in which Stanford addresses unallowable charges for indirect costs in its accounting system. This is the cause of many of the real and perceived problems which have been publicized.

Although Stanford has existing controls to ensure that direct costs for sponsored projects are reviewed for allowability, with respect to indirect costs, Stanford's current systems do not track and eliminate individual unallowable items to the same extent as the accounting systems used by most defense contractors. For example, to exclude unallowable entertainment expenses, Stanford and the Government formally agreed to deduct 20 percent from certain accounts in indirect cost pools. The use of such approximations or estimates to remove unallowable costs from indirect cost pools may be appropriate in some cases, but does not provide certainty that all unallowable costs have been removed from the University's invoices to the Government. Additionally, these methods do not provide an audit trail to assess conclusively the allowability and allocability of specific costs. Until very recently, however, Stanford and the Government have agreed that additional screening was neither beneficial nor required.

At this point in our review, we are unable to offer our independent assessment on the materiality of these practices. Regardless of their materiality, however, it is apparent that the lack of a clear audit trail has created at least the perception that Stanford's accounting system is inadequate. Ultimately, we may recommend that Stanford institute more stringent controls, similar to those used by defense contractors. Of course, such controls could substantially increase the cost of administering federal contracts and grants, and the Government would share in those higher administrative costs.

Our initial review has identified other areas of general inquiry where Stanford's existing controls may require strengthening. These include: (1) the adequacy of the training given to Stanford employees on the requirements of applicable government procurement regulations; (2) the scope of the Internal Audit Department's responsibility for monitoring compliance with applicable regulations; (3) the adequacy of the University's formal written policies and procedures in areas relevant to the current inquiries; and (4) the structure of the current accounting system, which may contribute to the risk of noncompliance with applicable regulations.

Our work is proceeding satisfactorily. We have met with the Audit Committee of Stanford's Board of Trustees and will be keeping them fully informed of our progress. We also have met with representatives of the Special Advisory Panel which was appointed by Stanford to review our report and advise President Kennedy on recommendations for improvements in Stanford's accounting practices.

I would also like to identify some additional factors that must be taken into consideration for any accurate assessment of the costs of sponsored research at Stanford. First, Stanford charges no fee or profit to the Government in contrast with commercial companies, who generally add significant fees to the cost of performing research. Further, by combining teaching and research, Stanford is able to staff government projects with research assistants (graduate and postgraduate students) at a fraction of the labor cost for similarly trained personnel at commercial organizations. This means that not only are Stanford's direct costs kept low, but the Government's allocable share of indirect costs is correspondingly lower.

Memoranda of Understanding (MOUs) between Stanford and the Government have recently been the subject of much discussion. Circular A-21 requires development of mutual understanding between universities and the Government as to the scope and interpretation of cost accounting principles. The MOUs were used to document those understandings. The fact that Stanford has a relatively large number of these agreements does not mean that the agreements were in any way inappropriate. Indeed, some of these, such as the agreements simplifying Stanford's calculation and allocation of equipment depreciation, were intended to save both Stanford and the Government money. As it now appears that these agreements are no longer acceptable to the Government, Stanford is taking steps to implement a system for item by item depreciation calculation and allocation. The costs of development of this system will be appropriately included in Stanford's indirect costs allocable to government contracts. We understand that Stanford has been quoted a price of approximately $800,000 to put such a system in place and roughly an additional $300,000 per year to maintain and operate that system.

There appears to be some public confusion regarding the nature of Stanford's indirect costs and which of those costs can be properly charged to the government. As a general matter, indirect costs are costs which are applicable to more than one university activity. By way of example, indirect costs include the costs of operating and maintaining the buildings in which research takes place. It has long been federal policy that the Government should pay for its fair share of the costs for sponsored research, which includes both the direct and indirect costs of such research. Under applicable regulations, the University is allowed to recover all of its allowable and reasonable indirect costs which are allocable to government research. The key test for the reasonableness of costs such as linens and flowers in the President's house is whether those costs are prudent and necessary for the overall operation of the University, despite the fact that they have no direct relationship to research. Major considerations involved in determining "reasonableness" include whether the cost is consistent with the University's established policies and practices, and whether the cost is prudent and generally recognized as necessary for the operation of the institution. We understand that Stanford's Board of Trustees has confirmed that these types of costs meet these criteria.

III. CONCLUSION

In conclusion, I want to reiterate that cost allowability issues frequently are not clear-cut questions. Competing issues of reasonableness, necessity and benefit must be addressed. As we continue our review, we hope that the results of our efforts will help Stanford to clarify many of the gray areas that have resulted in this controversy and that our recommendations will help Stanford meet its stated objective of improving its accountability as a steward for taxpayers' funds.

Clearly, educational institutions could adopt the costly accounting system controls and practices employed by dedicated defense contractors. Such a tactic would enable both Stanford and the Government to greatly reduce transactions that have received so much attention lately. The question is whether this is a necessary means to achieve reasonable assurance that the Government is getting its money's worth. It is a legitimate area of policy debate as to whether it is in the Government's best interests to incur the added costs necessary to achieve these greater levels of certainty.

Thank you.

Mr. **Wyden**. Thank you.

Mr. Gaither.

TESTIMONY OF JAMES C. GAITHER

Mr. **Gaither**. Thank you, Mr. Wyden.

Given the hour and the fact that you have my written testimony, I will defer making any further comments at this time, but I am available to answer any questions that you may have.

Thank you.

Mr. **Wyden**. Thank you.

[The prepared statement and attachment of Mr. Gaither follow:]

Testimony of James C. Gaither, President, Board of Trustees, Stanford University

Mr. Chairman, Members: I am James C. Gaither, President of the Board of Trustees of Stanford University.

Thank you for the opportunity to appear before you to make a brief statement regarding the appropriateness of certain expenses incurred in the operation of the Lou Henry House, the university-owned residence for Stanford's Presidents.

The expenditures which I will address fall into four categories:

1. The purchase of objects for the parts of the Hoover House that are commonly used for university events;
2. The purchase of objects for the President's family quarters in the Hoover House;
3. The services provided for the President and his family at the Hoover House; and
4. A reception held by the Board of Trustees for President and Mrs. Kennedy 10 days after their marriage in 1987.

Attached to this statement is a copy of the letter which I and all other Presidents of the Board of Trustees of Stanford University since 1976 sent to you, Mr. Chairman, earlier this month confirming our view that the expenditures in the first three categories are "important, reasonable and appropriate ones for Stanford University." As stated in that letter, the Hoover House is President Hoover's former residence, an historic landmark given to the university as a home for Stanford's presidents by Mr. Hoover in 1945. It has been and should, we believe, be maintained, and its furniture and furnishings repaired and replaced, in a manner appropriate to its distinction and to the important purposes for which it is used. It serves as the site for many events, ranging from receptions for parents of graduating students and dinners for visiting heads of state to events honoring leading faculty members and distinguished scientists from other institutions, academic seminars and Trustees Committee meetings. The personal quarters used by the president and his family during his term in office are, as might be expected, furnished and maintained in a similar fashion.

The services provided for the President and his family are also appropriate University expenses. The university makes extraordinary demands upon its President and assistance with personal matters is provided so that he and his wife can be available for the virtually endless list of University functions.

The last item, a reception for Dr. and Mrs. Kennedy, was also an appropriate University expense. About 10 days after their marriage in 1987, the Board of Trustees held a reception for them which included several hundred members of the Stanford faculty, Deans, Trustees and Stanford associates. The reception, which was initiated and organized by the Board of Trustees, recognized the important role which the President and his wife perform together in many aspects of University life.

As I believe the subcommittee knows, the university has decided to withdraw all of these items from Stanford's reimbursable indirect cost pools. They were withdrawn not because they were improper under government regulations, but rather because of their appearance. Without detailed explanation, many of them appear to be unreasonable or inappropriate.

Stanford must have an accounting system for expenses like these which not only complies with government regulations but which also produces results that appear to be fair and reasonable. This cost pool did not achieve that result and we intend to change it.

I hope this presentation has been helpful in clarifying a situation which has attracted much public attention.

Thank you.

THE BOARD OF TRUSTEES
THE LELAND STANFORD JUNIOR UNIVERSITY

March 1, 1991

The Honorable John D. Dingell, Chairman
Subcommittee on Oversight & Investigation
Committee on Energy and Commerce
U. S. House of Representatives
2323 Rayburn House Office Building
Washington, D. C. 20515-2216

Dear Mr. Chairman:

As Presidents of the Board of Trustees of Stanford University from 1980 through the present, we would like to share with you our views regarding the necessity and propriety of expenses incurred in the operation of the Lou Henry Hoover House, the University-owned residence for Stanford's presidents.

We do not address the separate policy issue of indirect cost charges to the government which is the subject of your upcoming hearing. We should, however, note that all costs in the Hoover House operations account submitted from 1981 forward have been removed from Stanford's reimbursable cost pools, and the University will negotiate with the government how to handle such costs in the future.

Our view has been and continues to be that the Hoover House expenditures are important, reasonable and appropriate ones for Stanford University. In the balance of this letter, we will explain the basis for that view.

We understand that the questions have been directed at three types of expenses:

1. Purchase of objects for the Hoover House that are of high quality and relatively costly;

2. Purchase of objects that might be considered personal to the president and his family, although they belong to the University and will remain in the Hoover House; and

3. Services provided to the president and his family that might be considered personal in nature.

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In the first category are items such as silver, crystal, china, flower arrangements, table linen, antique tables, chairs, desks and other furniture, expenses of refinishing the piano or other furnishings and the cost of upholstery, draperies, and carpets. The Hoover House was received by the University in 1945 as a gift from President Herbert Hoover. It is a federally designated historic landmark and it serves as the site for many important University events. It should be furnished and maintained in a manner appropriate to the University functions for which it is used. Whether it is used for a reception for parents of graduating students, a dinner honoring our Nobel laureates, a function for a visiting head of state, or a reception for a research symposium, the fact that the Hoover House also serves as the president's home transforms those functions from impersonal ceremonies into events in a personal setting that reinforce and promote Stanford's character as a community of scholars and students. The Hoover House is a beautiful and precious part of Stanford's, and the nation's, heritage. (President Hoover was in residence when he learned of his election to the nation's highest office.) It should be maintained, and its furnishings repaired, replenished and replaced, in a manner appropriate to its distinction.

The obligation to maintain the Hoover House in an appropriate manner also applies to the second category of furnishings. This category includes the cost of furnishing and refurbishing the private quarters of the Hoover House (the family bedrooms and bathrooms, for instance) and items such as towels, curtains, bath fittings, and the "cedar closets" which have received so much public attention. (With respect to this last item, it should be noted that the closets were repaired because the roof of the Hoover House leaked and the clothes in the closets mildewed. The problem was in fact not cured until the roof was rebuilt as part of the earthquake reinforcement three years ago.)

The Board has required all presidents of the University since 1945 to reside in the Hoover House, and we have provided appropriate furnishings. All of the items in the second category belong to the University and are used by the president and his family during his term in office. It is, we believe, completely appropriate to maintain the living quarters of the Hoover House in a manner commensurate with its more public rooms, and in our view, the expenditures for these items are consistent with this standard.

The third category consists of services provided to the president and his family, such as the salaries of staff and household help and their reimbursement for mileage in connection with errands which may be wholly or partly personal to the president or his family, payment for phone service, other utilities and the like. These items are also appropriate Stanford expenses. The presidency of this University is a demanding and all-encompassing responsibility. The University expects, and receives, the full-time availability of the president and his wife for University functions. The University helps to make this possible by providing various forms of assistance that are essential to free the President from personal tasks so that he can devote time to more important University responsibilities. The benefits of having Dr. and Mrs. Kennedy available for the extraordinary demands of the presidency far outweigh the costs of providing those services.

Finally, we wish to set forth some of our own views about the current occupant of the Hoover House, President Donald Kennedy. He has served Stanford with distinction for 30 years, as teacher and scientist, as department chair, as provost, and for the last ten years as president. His commitment to public service, his broad vision, his tireless efforts, and his accomplishments have set the highest standards for the educational community. He has contributed very significantly to our society and Stanford has been enormously fortunate to have his leadership during the past decade.

Sincerely,

James C. Gaither

James C. Gaither
President of the Board of Trustees
(1988 - present)

Warren Christopher

Warren Christopher
President of the Board of Trustees
(1985 - 1988)

William R. Kimball
President of the Board of Trustees
(1981 - 1985)

Peter S. Bing

Peter S. Bing
President of the Board of Trustees
(1976 - 1981)

copies: Admiral William C. Miller
Office of Naval Research

Mr. John M. Ols, Jr.
General Accounting Office

Mr. William H. Reed
Defense Contract Audit Agency

Mr. **Wyden**. Why don't we begin with the gentleman from New York.

Mr. **Lent**. Thank you, Mr. Chairman.

Dr. Kennedy, approximately how much money in Government research grants does Stanford receive every year from the Federal Government?

Mr. **Kennedy**. This year it is around $240 million.

Mr. **Lent**. And can you tell us approximately what percentage of Stanford's consolidated budget these research grants from the Federal Government represent?

Mr. **Kennedy**. It would be a little less than a quarter of our consolidated budget. Somewhere between 23 and 25 percent; something like that.

Mr. **Lent**. Did Stanford employ a screening mechanism of any sort to prevent unallowable costs, such as liquor or lobbying expenses or public relations, from being included in the indirect cost pool used to calculate the amount of indirect cost to be paid by the Government?

Mr. **Kennedy**. As has been mentioned earlier from this witness table, Mr. Lent, that was the subject of a Memorandum of Understanding which took a 20 percent disallowance based on a study done in the 1970's, from all general and administrative subsistence accounts in the university.

It was agreed between Stanford and the Government—and that, by the way, was done at least during 2 years for which audits were closed and approved by DCAA, and so that is meant to remove those two categories of unallowable expense.

Mr. **Lent**. Were not lobbying expenses included in your billings to the Federal Government?

Mr. **Kennedy**. I don't believe——

Mr. **Lent**. In other words, lobbying expenses were not included in that MOU?

Mr. **Kennedy**. No, lobbying expenses were not the subject of that MOU.

Mr. **Lent**. But they were charged to the Government?

Mr. **Kennedy**. I have no knowledge that they were. I need to ask for help on that, Mr. Lent, from some of my colleagues. I am certainly not aware that they were.

Janet, can you?

TESTIMONY OF JANET SWEET

Ms. **Sweet**. Lobbying expenses, until November 1990, were not one of the unallowable costs in the higher education cost principles of A-21 or FAR 31.3. So lobbying expenses were not removed.

Mr. **Lent**. Lobbying expenses were not removed; that means they were charged to the Government?

Ms. **Sweet**. That is correct. They were not unallowable until quite recently.

Mr. **Lent**. Was there any screening mechanism to root out these unallowable expenses?

Mr. **Kennedy**. For those unallowable expenses that are the subject of the MOU, Mr. Lent, there was no screening mechanism because the MOU took an agreed-upon disallowance that was supposed to cover those two categories. And as Janet Sweet just testified with respect to lobbying, that was not an unallowable activity under A-21 until 1990.

Mr. **Lent**. If Stanford could have a system to keep unallowable costs from being included in the cost pool, why could not that system have been expanded to examine other questionable costs and decide whether they should have been put in the cost pool?

Mr. **Kennedy**. Mr. Lent, I think that's right to the heart of the matter. We have an accounting system that does not at the point of entry into our transaction system, that is in the hands of the person undertaking the expenditure, a review of allowability. And I think what you are suggesting is that we may well need one, and I think that's right.

Mr. **Lent**. Well, you testified that seemingly unallowable items like flowers and cocktail napkins are allowable, as I understand it, Mr. Kennedy, or perhaps it was Mr. Keevan who so testified, if they are "prudent." Is that correct?

Mr. **Keevan**. Yes, Mr. Lent. What I testified to was that if those costs are prudently incurred and needed for the overall operation of the university, that those costs would be considered allowable.

Mr. **Lent**. All right. So a pre-game football lunch in the Rodin Sculpture Garden for $6,200 in catering charges, that would be prudent, in your opinion?

Mr. **Keevan**. I haven't said that, Mr. Lent.

Mr. **Lent**. Well, do you think it is prudent?

Mr. **Keevan**. On the surface, without any facts, it is hard for me to tell, but on the surface——

Mr. **Lent**. Well, how about $17,730 for liquor, catering, shuttle bus for guests, rental of tents and heaters, rental of champagne flutes and silver trays, totaling $17,730. That happened to be the president's wedding reception. Do you think that was a prudent charge?

Mr. **Keevan**. I don't know about the president's wedding reception, but I think there is some confusion regarding whether that was his wedding reception or not, Mr. Lent. So perhaps that ought to be clarified first.

Mr. **Kennedy**. Mr. Lent, may I respond?

Mr. **Lent**. Yes, sir, certainly.

Mr. **Kennedy**. Oh, thank you very much.

I just wanted to make two quick points. First, the items that you have referred to are items that we have withdrawn, and I want to make it plain that since there was some confusion on this point, that the Hoover House items that have been questioned and that I said we were withdrawing, even though they were technically allowable, were withdrawn by a letter from Janet Sweet to ONR with copies to DCAA on January 23rd, and we would like to submit, since that issue has come before the committee, we would like to submit Ms. Sweet's letter to the subcommittee.

Mr. **Lent**. I have no objection, Mr. Chairman.

Mr. **Kennedy**. May I just say a word or two about the wedding reception, which is obviously a source of personal embarrassment? First——

Mr. Lent. Before you do that, let me just ask; these items were withdrawn after the subcommittee initiated the investigation. Is that correct?

Mr. Kennedy. They were withdrawn after—certainly after GAO was assigned the task of auditing Stanford, yes. They were withdrawn on January 23rd.

Mr. Lent. OK. Now the wedding.

Mr. Kennedy. Yes. We had a wedding reception, Mr. Lent, and we had it at a hotel, and I wrote a check for it myself. Ten days later the board of trustees, the Sunday night before its regular meeting, did give a large reception for senior members of the faculty, for many members of the Stanford community, to introduce my new wife and me around, and it was as you described, and those expenses have been taken out of the cost pools.

Mr. Lent. Had not the subcommittee launched the investigation, and had not you withdrawn these items, this $17,730, the pre-game football lunch, and I guess a whole laundry list here of other items I have in front of me, do you think they would have been charged to the Federal Government?

Mr. Kennedy. I think they are technically allowable, but as I have testified, Mr. Lent, I don't think they are appropriate, and that is why we have withdrawn them.

If your question is would we have discovered them without the accelerated audit activity that the committee's examination of practices at Stanford put into place, probably the answer is that we might only have discovered them quite a lot later. I hope we certainly would have withdrawn them regardless of how we discovered them.

Mr. Lent. And the two Voltaire chairs, $1,500 apiece, were they part of the withdrawal?

Mr. Kennedy. Yes.

Mr. Lent. And the pair of George II lead urns purchased at Los Gatos, were they withdrawn?

Mr. Kennedy. Those didn't have to be withdrawn, Mr. Chairman. I don't know why somebody got those on approval and executed a purchase invoice, but they were returned 2 days later, and Stanford was refunded fully for them. So they are not even at issue.

Mr. Lent. $6,000 for cedar closets installed because the president's clothes were mildewing from a leaky roof, paid to Expert Woodworking? Were they withdrawn? Was that charge withdrawn?

Mr. Kennedy. All of the charges in this category, Mr. Lent, were withdrawn, and mildew wasn't the problem, as much as running water.

Mr. Lent. I will be happy to yield to the chairman.

Mr. Dingell. Mr. Lent has just raised a question. We are talking about the two urns. The urns were procured on approval. The urns were returned. The urns were submitted as an allowable expense as a part of your overhead costs. Were the overhead costs ever changed to reflect the fact that these urns at twelve thousand and some odd dollars were returned, or were they not?

Mr. Kennedy. Well, they certainly should have been, Mr. Chairman——

Mr. Dingell. But they were not.

Mr. **Kennedy**. If they weren't, the mistake is certainly of the order of magnitude of the yacht. There is no reason why anything should be put in a pool and stay there if the university has been refunded for it.

Mr. **Dingell**. I thank the gentleman for yielding.

Mr. **Lent**. Thanks.

Mr. President, this morning the GAO testified about the silverware located at your house, at the president's house. I would like to discuss this issue for a minute. Is it not the fact that the silverware was donated to the Stanford Art Department?

Mr. **Kennedy**. It was part of a gift to the university, whose use was specified for art, and one other purpose.

Mr. **Lent**. So there was not any real cost to the university in obtaining that silverware; is that correct?

Mr. **Kennedy**. It was given to the university.

Mr. **Lent**. And the silverware subsequently was transferred from the arts department of the university over to your house, the president's house?

Mr. **Kennedy**. It was a gift that was part of a house that was given in its entirety to the university, but which the university was not using for purposes that required the silver.

Mr. **Lent**. OK. Now, is it not the fact that depreciation on the silverware was included as an expense in the indirect cost billed to the Federal Government as part of Stanford's general overhead, just like the cedar closets?

Mr. **Kennedy**. It was originally included as an expense in that pool, that is correct.

Mr. **Lent**. And if the silverware had been kept, then, in the Art Department, could its depreciation then have become part of the indirect costs to the Government?

Mr. **Kennedy**. Had it been kept where it was, it would not, nor would it have been used.

Mr. **Lent**. So how was the silverware included in the cost pool?

Mr. **Kennedy**. Because we had an obligation to the donor to make certain that that gift was used for the original purpose of the donation. Hoover House needed the silver. Hoover House would have had to make that purchase on the open market for as much or more. It therefore purchased the silver from that account, putting the money into the account for the restricted purpose which the donor intended, and transferring the silver to Hoover House. That transaction was based on an external appraisal of the value.

Mr. **Lent**. This silverware had a value of $10,000?

Mr. **Kennedy**. That was about the amount of the appraisal, yes.

Mr. **Lent**. But it was never paid by the university? The university got this as a gift?

Mr. **Kennedy**. Well, there was an inter-account transfer; but the silver originally came to the university as a gift; that is correct.

Mr. **Lent**. But the university never spent a penny for buying this silverware?

Mr. **Kennedy**. That is correct.

Mr. **Lent**. But the Federal Government was charged for it; is that not correct?

Mr. **Kennedy**. Because it was moved from one category of expense——

Mr. LENT. Yes or no? Was the Federal Government, the taxpayers of this Nation, charged $10,000 for silverware that was donated, free of charge, to the university's art department?

Mr. KENNEDY. Because of that transfer, it did wind up in that pool which is charged in part to the Government.

Mr. LENT. So the answer is yes?

Mr. KENNEDY. We have now withdrawn it, as you know, Mr. Lent. That is one of the items that has been withdrawn.

Mr. LENT. I am gratified to hear that. But your answer is yes, it was charged to the taxpayers of this country?

Mr. KENNEDY. Yes, it was, as an expense in that pool.

Mr. DINGELL. Will the gentleman yield?

Mr. LENT. I will be happy to yield.

Mr. DINGELL. Here you have silver that is donated to the art department, right?

Mr. KENNEDY. Right.

Mr. DINGELL. It was donated as an object of art?

Mr. KENNEDY. No; it was donated as part of a house that was given, with all of its furnishings, to the university, with the stipulation that it be used, that the process be used to benefit the Art Department.

Mr. DINGELL. Was any payment made inside the university from the university to the arts department to assist it as the grantor would have wished, or was this just simply turned over to the president's house for use?

Mr. KENNEDY. The silver went to the president's house, but there was an account transfer that benefitted the art department, as I understand it. I may need some help on this, but that is my understanding.

Mr. DINGELL. Was the art department given $10,000 by the university?

Mr. KENNEDY. Yes, in effect——

Mr. DINGELL. It was?

Mr. KENNEDY. There was a transfer of that value to that account.

Mr. DINGELL. Now, this silver was given to the university in a single lot, valued at $10,000. Why was it broken down into $500 segments?

Mr. KENNEDY. Mr. Chairman, I would only be guessing. I really do not know. I heard the testimony this morning suggesting that it was broken down so that it could be expensed rather than capitalized. I do not think that is the case. I believe that it was broken down because it came in different forms. There were different categories of silver, and I assume that they were appraised separately.

Mr. DINGELL. It all came at the same time, did it not?

Mr. KENNEDY. Yes.

Mr. DINGELL. OK. Who was it that broke this down into separate lots?

Mr. KENNEDY. Mr. Chairman, I do not know the answer to that. If my colleagues can help me, I would love it if they would do it, but I do not know the answer.

Mr. DINGELL. Well, it was broken down so it could then be expensed as opposed to being capitalized, is that right, and depreciated?

Mr. **Kennedy**. Well, I am not going to guess as to intent, Mr. Chairman, but that appears to have been the effect, that is, the individual components that were appraised fell below that threshold.

Mr. **Dingell**. The rules, however, did not permit the cost of this to be assessed against the Government unless it was broken into $500 or smaller lots; is that not right?

Mr. **Kennedy**. My understanding, Mr. Chairman, and I could be wrong, is that the rules would, either way, permit some inclusion in the pools, that is, it could be done on the basis of a one-time capital expense or it could be done on an annualized basis. But I am not directly familiar with that body of regulation, so I cannot go further.

Mr. **Keevan**. Mr. Chairman?

Mr. **Dingell**. I thank the gentleman.

Mr. **Kennedy**. Mr. Chairman, could Mr. Keevan help us with that? Is that OK?

Mr. **Dingell**. It would be appropriate if somebody could enlighten the committee.

Mr. **Kennedy**. Thank you very much.

Mr. **Dingell**. So far, the committee has a bad impression.

Mr. **Keevan**. Mr. Chairman, I cannot address the specific transaction you are discussing, but just as a point of clarification, so we do not get diverted, donated assets are properly capitalizable and then chargeable to the Government. Now, whether you have an amortization question, depreciation, or whether it should be expensed, now that is another issue. But typically, an asset, a capital asset may be donated. The university or the contractor, whoever it is, would not have to pay, but it would be capitalized at its fair value and then written off.

Mr. **Lent**. Thank you. Let us get off the silverware for a minute, and turn to the Stanford Shopping Center. President Kennedy, is it not true that about $700,000, representing the cost of administering Stanford's Shopping Center, were placed in the indirect cost pool, and billed to the Federal Government, in 1986 and 1987 combined?

Mr. **Kennedy**. That is my understanding, Mr. Lent.

Mr. **Lent**. Is it also true that in 1988 this charge was discovered and was then not included in the indirect cost for that year?

Mr. **Kennedy**. That's right. My understanding is that as the costs for 1988 were being examined, that was decided to be an unallowable element and was not put in the pool.

Mr. **Lent**. But is it not also true that Stanford has yet to pull it out of the indirect cost pool for the years 1986 and 1987?

Mr. **Kennedy**. Well, it is certainly our intention to pull them. How far we have gone with that I think Ms. Sweet can tell us.

Ms. **Sweet**. We have done that, and have communicated it to the Government.

Mr. **Lent**. Can you just tell us when you did that? Because we understand that many of these things that you say you are pulling out or that you have pulled out have not, at least formally, been pulled out.

Ms. **Sweet**. We will be glad to give you a copy of that document, too.

Mr. **Lent**. It was done, though?

Ms. **Sweet**. Yes.

Mr. **Lent**. It is a completed transaction?

Ms. **Sweet**. That is correct.

Mr. **Lent**. Can you tell us when, Ms. Sweet?

Ms. **Sweet**. I do not recall exactly when. But like I say, we will be glad to get you that document.

Mr. **Lent**. Was it very recently?

Ms. **Sweet**. It was recently within the last several weeks.

Mr. **Lent**. OK. Why is it that Stanford, Mr. President, never seems to want to do anything of substance, like taking out costs that should be clearly unallowable, on a voluntary basis? Why is it that Stanford always has to be confronted publicly with a cost before it will agree that it should be taken out?

Mr. **Kennedy**. Well, Mr. Lent, I do not think we do. I think that we can give the subcommittee examples of voluntary disallowances——

Mr. **Lent**. Just give us one.

Mr. **Kennedy** [continuing]. We have taken in the past.

Mr. **Lent**. Just give us one example of an instance where you voluntarily pulled something out of a cost pool before bad publicity resulted, before the subcommittee got in touch with you. Just one.

Mr. **Kennedy**. The best example I know of, because I happen to have been involved with it, because it was a fairly major policy decision, was the decision to take about 2 to 3 points less on our indirect cost rate in order not to have to have faculty effort reporting.

As to removal from particular cost pools, again, I would have to ask Ms. Sweet for some help, but I think she can give us an example.

Ms. **Sweet**. Mr. Lent, the examples that we have seen brought forward today are a series of errors. When we put together the indirect cost study for any year, there are many, many millions of dollars that are excluded voluntarily by the university in preparation of that indirect cost study. The kind of thing we are talking about right now are errors discovered during an audit process. And it is our policy to, when we discover errors, to notify the Government of those and correct them. If the Government discovers an error, we are willing to look at that and take that error as well. That is our practice and our policy, and we have done it very faithfully.

Mr. **Lent**. The chairman is asking for time.

Mr. **Dingell**. Time. The Chair is going to have a few questions here before we proceed over to the floor to vote.

Dr. Kennedy, if the Chair understands your testimony correctly, your contention here is that there are a lot of associated costs in running a University in support of research that must be recuperated in terms of making the institution whole in order to enable an institution like Stanford to be able to afford to conduct the research. Is this correct?

Mr. **Kennedy**. Yes, that is correct.

Mr. **Dingell**. OK. So there I would assume that if the Federal Government arbitrarily capped its indirect cost rates at 10 or 20 percent, Stanford would be in a position of not being able to afford to conduct the research, or would be forced to subsidize the Government from other funds belonging to the university; is that correct?

Mr. **Kennedy**. It would be forced to subsidize it more than it is now, and it already is cost sharing to a considerable extent.

Mr. **Dingell**. So the function then of the overhead is to assure that the university does not bear costs, or does not subsidize costs of research; is that correct?

Mr. **Kennedy**. No, I do not think so.

Mr. **Dingell**. What is the purpose, then, of the overhead?

Mr. **Kennedy**. I stated, Mr. Chairman, that it is to reimburse costs that the university has expended out of its own funds in order to support the activities that are required to support research but cannot be associated with particular projects.

Mr. **Dingell**. All right. I accept that. And, having said that, if you were not made whole with regard to those costs, you would be compelled then to subsidize the Government for the research which is being done; is that right?

Mr. **Kennedy**. Yes, Mr. Chairman. I would only add that we are not made entirely whole now. We are already cost-sharing. So we are talking about an increase, not doing something——

Mr. **Dingell**. Now, Dr. Kennedy, I have a curiosity. The Chair has found in the course of these matters through the activities of the staff that in 1988, 1989, and 1990, Stanford conducted research for the Government of Japan. In 1988, it conducted research for Matsushita, which is a large Japanese electronics company. In each of these cases, Stanford waived all overhead charges to the Japanese.

Can you explain to me why Stanford would be willing to waive all overhead costs there, subsidizing the Japanese Government, as opposed to the U.S. Government, when it is getting its full share from the American taxpayer?

Mr. **Kennedy**. Mr. Chairman, I would need to look into those particular cases. Let me tell you what the policy is because we have reviewed it during the past year and I have insisted on its application.

We do not give any government a break on indirect cost recovery. We have refused grants from outside governments that insisted on below standard indirect cost reimbursement or no indirect cost reimbursement at all.

Now, we have permitted, rarely, grants from private foundations or private organizations that do not customarily pay overhead in areas where we find it very difficult to get Government research support to be subsidized with our own general funds. We do not like to do it, but we do to it some.

Mr. **Dingell**. The records of this committee indicate that no assessment of overhead costs were made against the Japanese Government in 1988, 1989 and 1990, and that none were assessed against Matsushita when work was done for either the Japanese Government or for this particular Japanese firm.

This happened during your tenure as president. Can you explain to me why it happened?

Mr. **Kennedy**. You are telling me a fact that has not been brought to my attention with respect to Matsushita. With respect to the Japanese Government, I know of at least two grants from that source that are carrying standard overhead for those kinds of grants. So, if you will permit us to respond later, for the record, Mr. Chairman, on the Matsushita case, we will be glad to do that; but this is news to me.

Mr. **Dingell**. I note that you were accompanied by your Controller, Mr. Riddle, by your Assistant Controller, Ms. Sweet. Can you explain to us why it was that there were no overhead charges assessed in connection with these research programs to which the Chair has just alluded?

Mr. **Sweet**. I, too, would have to look at the particular situation.

Mr. **Dingell**. What is the standard overhead which is assessed by Stanford against the persons who contract with it for research?

Mr. **Kennedy**. Well, the provisional rate for this year, which I assume you are asking about is 70 percent.

Mr. **Dingell**. Seventy percent. What was it last year?

Mr. **Kennedy**. It was 74 percent last year.

Mr. **Dingell**. What was it the year before?

Mr. **Kennedy**. I think it was 74 percent, I do not remember the exact year that it jumped.

Mr. **Dingell**. Now, the committee has just made available to you a copy of a report highlighting some of the examples that the Chair has been alluding to. Can you look at the indirect costs there please, doctor? Maybe you would want to share that with Ms. Sweet or with Mr. Riddle.

Mr. **Kennedy**. No, I have it here.

Mr. **Dingell**. What does it say?

Mr. **Kennedy**. Well, I am just trying to work my way through the columns, Mr. Chairman. It has columns for salaries, equipment, S&E stipends, total direct expense and reimbursed indirect expense and that is zero for the grant that you have marked in yellow from the Government of Japan.

I can now go a little farther with this because I know who the faculty member is whose name is associated with the grant, it is Professor——

Mr. **Dingell**. Who is the faculty member who was the recipient?

Mr. **Kennedy**. Professor Ward, which tells me that it is a grant to the Institute for International Studies, and I think it is the case that some grants that essentially involve cooperative international programs or exchange programs, do not carry overhead at all because they are designed to further international cooperation. I would suspect that it falls under that kind of exemption; but as I say, I would need to see the project proposal and inquire of the investigator and of the Director of IIS why it fell under that exemption.

Mr. **Dingell**. Well, let's go then to another one. In 1989, Stanford conducted research for a rather impoverished U.S. Corporation, the Exxon Corporation. All overhead was waived. Can you explain to us why that occurred? This is not international cooperation.

Mr. **Kennedy**. Well, Mr. Chairman, there are various conditions under which overhead is waived by exception, and unless I knew this case, I could not tell you why. We do, by the way, waive overhead by standard exception for Government entities too. We only collect quite low overhead rate on training grants, for example, from the Government. So, there are exemptions of various kinds and they serve various purposes. Again, to tell you which purpose this one served, I would have to know about the particular project.

Mr. Dingell. Now, Doctor, the Chair, in a reviewing of papers, has found that Stanford also performs biomedical and other research for the largest most profitable multinational pharmaceutical corporations such as Pfizer, Upjohn and Ciba-Geigy. Again, in many cases, little or no overhead was charged. What comment would you like to give me on that?

Mr. Kennedy. Well, it is sometimes the case that I know that Stanford will participate in multi-center clinical trials for the development of important drugs or devices and that some of those have special overhead arrangements. Again, Mr. Chairman, I would have to review the particular projects. I do not, I am sorry to say, look at every one that comes in. So I cannot give you the reasons for exemptions in these particular cases.

Mr. Dingell. Well, let's now address Stanford School of Medicine. They conducted research for a very well-known organization—Weight Watchers—in 1990. Again, overhead was waived. Why would Stanford want to waive overhead as regard to Weight Watchers?

Mr. Kennedy. Well, a variety of improbable suggestions come to mind, Mr. Chairman, but I think I will not try any of them. I do not know. Again, I would have to look at that particularly.

Mr. Dingell. Well, you are charging the Federal Government at these times, the full 74 or 76 percent overhead.

Mr. Kennedy. For regular research grants, yes.

Mr. Dingell. Now, I note that Weight Watchers is concerned with weight. Why are not similar benefits given to the Federal Government for AIDS Research?

Mr. Kennedy. Well, Mr. Chairman, as I have said, the problem of on what basis we award waivers of indirect costs to particular sponsors depends very much on the individual case. I will be very happy to respond on a case-by-case basis, when I know them; but I really would appreciate a chance to do that and get back to you on it, because I cannot do it here.

Mr. Dingell. The Chair is driven to the regrettable conclusion that the Federal Government is charged the full, the Japanese are not; the Federal Government is charged the full, Weight Watchers are not; the Federal Government is charge the full, Ciba-Geigy, Pfizer and others are not; and we have a—this impoverished corporation, Exxon, is not charged overhead, whereas the Federal Government is, again, charged the full tab. Does this seem to bring to your mind that perhaps we have an anomalous situation or perhaps an unfair situation here?

Mr. Kennedy. No, Mr. Chairman, it does not. You have mentioned cases where we have given waivers or awarded grants or contracts at lower rates to particular organizations. Our standard rate for industry is the same as for Government; in fact, it used to be higher until very recently. These exemptions——

Mr. Dingell. Now it is low because Exxon pays zero.

Mr. Kennedy. These exemptions are few in number and I think each will have an individual explanation when I have a chance to give it to you. I want to emphasize it is not true that we generally exempt Japanese corporations or foreign governments. It is true that certain Federal programs get exemptions.

Mr. **Dingell**. The Chair is going to ask you to assist us by identifying every case in which overhead was waived and to give us an explanation as to why the overhead, in each of these instances, was waived.

Mr. **Kennedy**. I will be glad to respond, Mr. Chairman.

Mr. **Sikorski**. Mr. Chairman.

Mr. **Dingell**. The Chair requests the gentleman from Oregon to take the Chair. The Chair has got to run over and vote. I will be back as quickly as I can. Mr. Wyden.

Mr. **Sikorski**. Mr. Chairman, perhaps with unanimous consent, the examples of contracts for overhead was waived or capped below the general university rate document be put in, if appropriate.

Mr. **Wyden** [presiding]. Without objection, that will be entered into the record.

Mr. **Sikorski**. If appropriate.

Mr. **Wyden**. Dr. Kennedy, I have a few questions, but first want you to at least hear my views, at this point.

I think that this is a very sad day for one of the world's great universities. Speaking both as a Stanford graduate, as a taxpayer, I never thought that one would see this day where the president of Stanford University was going to be sitting where you are and asked to explain why antique fruitwood commodes were billed to the taxpayer; why Weight Watchers was given a free ride. I just think this is a very sad day to face this set of charges and debate as we have. I have got some specific questions.

I want you to understand that I think that this is not primarily a debate about technical rules; about A-21 circulars and the like. I think that every taxpayer in this country looks at these kinds of charges and says these charges are wrong.

Ultimately, what I want to hear from the university today is that you are going to take steps personally to change the direction of what is being done on campus with respect to these reimbursement systems, so that these charges do not happen again.

We are going to debate technical issues with you, and it is going to go on for hours. Ultimately, I think this has to come from the president's office and it has got to start there. The new accountability that I and others have talked about needs to start right in your office. What steps do you intend to take so that this kind of sorry pattern of charges and discussion is not repeated?

Mr. **Kennedy**. I think I have already indicated several steps that we have taken and intend to take. I summarized our engagement with Arthur Andersen and Mr. Keevan and his group. We are responding to audits and to audit findings to the best of our ability to keep up. We have taken on additional personnel to help with that response.

We have withdrawn costs from the pools where that has seemed appropriate to us, and we are determined to improve our systems in ways that Mr. Keevan is going to help us improve them, and I certainly intend to take personal responsibility for that.

As to its being a sad day for Stanford, Mr. Wyden, I think that there are probably aspects of sadness about it, but I think there are also some—I think there is also some real cause for concern about some of the things that have been—have been said here.

I am concerned about what I think are rather loose implications of prospective criminal action against people at Stanford, suggestions that I do not think have any significant evidence behind them.

We have been charged by the Defense Contract Audit Agency with being obstructionist.

We are, I promise you, doing our best to deal with 30 Government auditors with a staff of 15 who have to answer their questions, and we are trying to—we are trying to create and then to follow reasonable protocols for prioritizing those requests and responding to them. We are going to continue to do that as actively and as effectively as we can.

Mr. **Wyden**. Well, if I might just continue on this point, Dr. Kennedy, I do not think you have heard any loose criminal charges from this side of the dias.

I think the members on both sides of the aisle have been very careful to address some matters that are documented, referring to records, and I would only say that—I mean we heard from Mr. Biddle, for example, of substantial skepticism about some of these proposals for the future.

You heard me ask him about this matter of Stanford going back and scrubbing the charges, and he said that he really questioned whether the people who were involved—and we are talking prospectively now, not retroactively—he has questioned whether the people, prospectively, have the kind of expertise and the commitment to really get on top of this problem.

Now, weren't you a little bit concerned when Mr. Biddle was talking about some of these prospective changes and questioning whether or not they had the expertise to turn this problem around?

Mr. **Kennedy**. Well, from what I heard from Mr. Biddle, he alluded to a rather short conversation with a representative of Arthur Andersen and appeared not to be satisfied with his experience.

We shopped very carefully for this engagement, Mr. Wyden, and we are assured by an array of people whose advise we sought that, indeed, we have made the best engagement possible, and I have great confidence not only in our people's motivation to carry out and to help conclude these audits but also in Mr. Keevan's skill and the skill of his colleagues.

Mr. **Wyden**. Doctor, can you give the subcommittee some examples of these allowable charges that were included in the overhead pools where Stanford, in effect, found them before the Government, brought them to the attention of the Government?

Mr. **Kennedy**. Well, I cannot at this time. When asked that question before, Mr. Wyden, I referred it to Ms. Sweet. I think she answered it, but perhaps—perhaps she would like to say it again or comment further.

Mr. **Wyden**. Well, let us just talk about the last decade of charges. Can you give some examples, again to try to show that Stanford is getting on top of this problem and not just shuffling it off, that would indicate that it can find these unallowable charges and bring them to the Government, rather than the Government having to chase the university down?

Ms. **Sweet**. In the preparation of our indirect cost studies, as I indicated earlier, there are multiple millions of dollars, I would say somewhere between $15 and $20 million a year, that are, in fact, scrubbed, the verb that some have used earlier today, from the indirect cost submission.

So, we pay particular attention, before we make a submission to the Government of our indirect cost studies, to see to it that unallowables are excluded.

Mr. **Wyden**. What about, Ms. Sweet, past costs that have already been submitted? Can you give us some examples of where Stanford saw the problem first and brought it to the Government's attention, since this investigation even?

Ms. **Sweet**. Well, the investigation has been all-consuming for us. So, most of what has been found within the last few months has been found as a direct result of responding to auditors' questions. I would say we have spent——

Mr. **Wyden**. Has Stanford found even one example of these unallowable charges and brought it to the Government since the investigation?

Ms. **Sweet**. Since the investigation? Like I say, we have spent 100 percent, 100 percent of our time, probably beyond 100 percent, in responding to the multiplicity of auditors.

So, we have not been engaged in anything but responding to Government auditors in the last several months, but in the last 10 years, we could certainly provide you with a number of occasions, and I have got several here if you would like me to——

Mr. **Wyden**. I think the fact that the university cannot give this subcommittee today even one example of past specific costs since the investigation that they found as a problem does not breed a lot of confidence that this problem is being turned around.

Ms. **Sweet**. I have several——

Mr. **Kennedy**. May I comment, Mr. Wyden? There are now 22 DCAA auditors at Stanford, about 8 other auditors.

We have got a comptroller's staff of 16, to which we have added, I think, half a dozen temporaries, and they are, at my direction, spending full time responding to DCAA requests for audits. We have 3,700 DCAA requests. We are behind on responding to them. No one in that shop, Mr. Wyden, is doing anything but servicing DCAA and GAO auditors, nothing.

Ms. **Sweet**. Mr. Wyden, if you would like for me to give you examples of situations prior to that, I would be glad to. I have several here, and we could give you a more comprehensive list later. If you want some examples right now, today, I have some.

Mr. **Wyden**. No. I know that you are spending a lot of time with auditors and, particularly, Arthur Andersen, who you all have brought on, but I just think the fact that you cannot give one example——

Ms. **Sweet**. I can.

Mr. **Wyden** [continuing]. Of a specific cost since this investigation where the university brought it to the Government is not going to inspire a lot of confidence in people that this problem is being turned around.

Mr. KEEVAN. Mr. Wyden, I would just like to clarify something. While the university is spending a fair amount of time with Arthur Andersen and Company in connection with the controls review, I do think it is important that I point out that the number of DCAA auditors and GAO auditors is substantial and requiring a lot of time, and I think it is appropriate to be aware of that.

Thank you.

Mr. FITZPATRICK. Mr. Wyden, I think Ms. Sweet had some examples that she would like to give.

Mr. DINGELL. Mr. Chairman, the practices of the subcommittee, I would remind all present, are that all persons who are here to testify, do so under oath.

Mr. Fitzpatrick, I would be delighted to administer the oath to you and permit you to testify if you so desire. That will, unfortunately, cause you to waive your responsibilities as attorney and advisor to the gentlemen who are present.

I know you do not want that, and I do not.

Mr. FITZPATRICK. I was merely pointing out that I thought Ms. Sweet—I thought Mr. Wyden might not have heard Ms. Sweet offering to give some examples.

Mr. DINGELL. We appreciate your assistance, but when she is here before the committee, Ms. Sweet is very much on her own, except as she might have an attorney-client relationship with you.

Ms. SWEET. Would you like to hear the examples that I have?

Mr. WYDEN. I would.

Ms. SWEET. OK.

Mr. WYDEN. Let us make it clear that we are talking about since the investigation, where you have scrubbed and gone back and found a specific cost that was unallowable, brought it to the Government, and it was previously submitted.

Ms. SWEET. Mr. Wyden, as I indicated earlier, we have been spending incredible resources adding staff. We probably have three times the staff onboard now that we normally have, and we are not able to do our ongoing current work. We are totally responding to auditors.

I do have considerable examples, during more normal times, when we have, in fact, found and notified the Government of errors that we have found.

Mr. WYDEN. I have got to recognize my colleagues, but I think the point is, Ms. Sweet, you understood me perfectly well the first time, and you had various people come up from the audience, and you still could not give us one example, not one, since the investigation started where there was scrubbing, where you could find a specific cost that had been submitted, and the university took it back, and that does not, it seems to me, suggest that the university is on top of it.

Ms. SWEET. I feel this is an unfair line of questioning given the circumstances we have been under in the last 6 months.

Mr. WYDEN. Well, I will certainly note that you think it unfair, but I think what the taxpayers of this country, who have been sitting here for 5 hours and listening for examples as to why it may be reasonable to have a $1,200 19th century Italian fruitwood commode billed to the taxpayers as part of running the university would like to know specifically how this is going to be turned around.

Mr. Biddle said, for one, that he had some serious questions about whether some of the people, like Arthur Andersen, had the expertise to do it.

I wanted to know about specific examples that would suggest, from the beginning of this investigation, that Stanford was going to go back, scrub the charges, look at those that had been submitted and retract those that were unallowable, and you all could not give one.

So, I am very anxious—and we will plan to stay as long as Chairman Dingell allows—to hear about these efforts the university is making to turn this around, but from what I have heard, there is a considerable distance to go.

Let me recognize the gentleman from Virginia.

Mr. BLILEY. Thank you. Dr. Kennedy, did Stanford have to certify the cost in the indirect cost pools in any way?

Mr. KENNEDY. You mean, the standard form of certification that was discussed this morning?

Mr. BLILEY. Yes.

Mr. KENNEDY. Yes, Mr. Bliley, it did.

Mr. BLILEY. Who signed such certifications?

Mr. KENNEDY. Mr. Riddle signed those, I believe; is that correct, Frank?

Mr. RIDDLE. That is correct.

Mr. BLILEY. Did you sign the certifications then, Mr. Riddle, that included the yacht depreciation and the expenses for the president's house?

Mr. RIDDLE. No, sir, I signed the certification indicating that, to the best of my knowledge and belief, there were no unallowable costs contained in the submission.

Mr. BLILEY. Well, did you review the costs before you filed them?

Mr. RIDDLE. Yes, sir, I always follow a normal due diligence.

Mr. BLILEY. Well, if you reviewed them, how come you didn't come across the expenses for the depreciation on the yacht and the expenses of the president's house?

Mr. RIDDLE. First, I don't believe the expenses of the president's house to be unallowable.

Mr. BLILEY. Flowers for the president's house, you believe are allowable?

Mr. RIDDLE. I believe, according to the Government guidelines, as I have read them and interpreted them, those costs are reasonable costs in the operation of the university and that they would be allowable, allowable in part.

Mr. BLILEY. How about the yacht?

Mr. RIDDLE. Sir, the yacht was a flat out mistake. It was embarrassing to the institution. It's embarrassing to me as controller of the university. It has been removed from our costs.

Mr. BLILEY. How about the antique commode?

Mr. RIDDLE. Sir, I'm not familiar with the antique commode.

Mr. BLILEY. Well, it's a 19th Century Italian fruitwood commode, $1,200.

Mr. **Riddle**. Sir, I'm not familiar with that individual transaction. If this is part of the transactions for the president's house, they have been removed and what I said earlier stands.

Mr. **Bliley**. How about the Shopping Center; did you certify that, too?

Mr. **Riddle**. Sir, I repeat what I did say before; I certified to the submission. Had I been aware that the Shopping Center was in there, I would have had it removed. It was also an embarrassment.

Mr. **Bliley**. When you were getting ready to sign this certification that these charges were, indeed, proper; how much time did you spend each year or each period examining the charges to make sure that, indeed, they were, in fact, allowable?

Mr. **Riddle**. Sir, I cannot give you a particular time I do spend. I, as University Controller, am responsible for a $1.2 billion enterprise. We have about 3 million transactions a year that flow through the accounting system. I do not check them all.

Mr. **Bliley**. Well, what system did you have to examine the indirect cost pool, even on a test basis to see whether the charges included in it were appropriate to make to the Government?

Mr. **Riddle**. That screening process takes place at the time the indirect cost study is constructed.

Mr. **Bliley**. I'm sorry; would you repeat that?

Mr. **Riddle**. That screening normally takes place at the time the indirect cost study is constructed. As Ms. Sweet has testified, they removed many millions of dollars at that time as unallowable costs.

Mr. **Bliley**. Do you believe that the system was adequate?

Mr. **Riddle**. I believe that the system of internal controls at Stanford University is a normal internal control system for higher education.

Mr. **Bliley**. That's a pretty good answer because I'm confused as to whether it's yes or no. Maybe we better go over it again.

Mr. **Rowland**. Would the gentleman yield?

Mr. **Bliley**. I'd be happy to yield to the gentleman from Georgia.

Mr. **Rowland**. If that is normal, do you think that the same type of situation exists in other universities throughout the country?

Mr. **Riddle**. I'm sorry, sir, I can't respond directly to that.

Mr. **Rowland**. I believe that you said that the system of internal control that Stanford has is a normal type of system for a university, is that correct?

Mr. **Riddle**. As I understand it, yes.

Mr. **Rowland**. Well, then, do you think that other universities throughout the country may have the same type of difficulties going on at Stanford now if they have a similar type of system of internal control?

Mr. **Riddle**. They would.

Mr. **Rowland**. Well, that certainly raises an interesting point. I yield back to the gentleman.

Mr. **Bliley**. Mr. Riddle, getting back to the Shopping Center, those charges; has any of that depreciation money been paid back to the Government for 1987 or 1988?

Mr. **Riddle**. I would have to defer that to Janet Sweet to answer whether that's been removed.

Mr. **Bliley**. Ms. Sweet?

Ms. **Sweet**. Those costs were administrative costs and not depreciation and the 2 years that were involved were 1986 and 1987; did not include 1988. That was a situation where we have recently indicated that those were incorrect costs. We discovered the error in 1988.

Normally, we would have communicated that there was an error in 1986 and 1987. It is not known to us, what the situation was back at the time we handled it correctly in 1988. We would normally have communicated that.

Mr. **Bliley**. Well, in 1988 when you discovered this, did you go back and correct the situation and——

Ms. **Sweet**. That's what I was just saying. Our normal practice would have been to do so. In this case, we didn't and so I'm not sure whether the person who found this and corrected this in 1988 didn't go back and look in 1986 and 1987 to see that there was a problem. That's just lost to history. We have, in fact, corrected that now. That document, we will be glad to provide to you.

Mr. **Bliley**. When did you find out that you hadn't paid the money back.

Ms. **Sweet**. Please ask the question again.

Mr. **Bliley**. When did you first find out that you hadn't paid the money back for 1986 and 1987.

Ms. **Sweet**. When the GAO discovered this in the fall in their audit findings.

Mr. **Bliley**. Fall of 1990?

Ms. **Sweet**. The fall of 1990, right.

Mr. **Bliley**. OK, if you found it now, since the fall, have you paid it back yet?

Ms. **Sweet**. The university operates with a fixed carry forward rate situation with the Federal Government, so this is an adjustment to the carry forward and that adjustment has been made.

Mr. **Bliley**. Thank you, Ms. Sweet. Mr. Riddle, if you believe that the system was adequate, why then did you—why has Stanford now agreed that the expenses in the President's home be withdrawn?

Mr. **Riddle**. Sir, that decision was not my decision. That was the decision of the president.

Mr. **Bliley**. Perhaps Dr. Kennedy would like to answer.

Mr. **Kennedy**. Yes, I will be glad to, Mr. Bliley. We withdrew those costs, even though they are technically allowable because I wasn't comfortable with them, because I don't think they contributed to public credibility and because I felt we'd be better off without them, so we took them out.

Mr. **Bliley**. When did you become uncomfortable enough to decide to withdrawn them?

Mr. **Kennedy**. We made the decision on January 8, and I think the letter withdrawing them is 1 or 2 weeks later, the 23rd, perhaps. We'll submit that letter. I've already said we're going to submit that letter to the subcommittee.

Mr. **Bliley**. This is 1991?

Mr. **Kennedy**. Yes.

Mr. **Bliley**. Thank you very much. Thank you, Mr. Chairman.

Mr. **Dingell**. The Chair thanks the gentleman. As chairman, it falls to my duty to see to it we have an orderly record. Ms. Sweet, the Chair reminds you that you are under oath. The Chair notes that none of the Government agencies who were inquired of today with regard to the return of the moneys with regard to the depreciation on the Shopping Center are aware that there has been any return. Are you sure you don't want to rethink your answer before us?

Ms. **Sweet**. The letter was faxed to the GAO, to ONR and to DCAA.

Mr. **Dingell**. When was that?

Ms. **Sweet**. I don't know the exact date, but like I say, we'll be glad to get you a copy of the letter, and it was faxed to them.

Mr. **Dingell**. Can you give us an approximate date?

Ms. **Sweet**. I would say it was 1½ or 2 weeks ago, something like that.

Mr. **Dingell**. I beg your pardon?

Ms. **Sweet**. A week and a half to 2 weeks ago, approximately.

Mr. **Dingell**. The timing was admirable. Now, the staff has expressed great curiosity on this. You learned about it in the Fall. Why did it take you from last Fall which is a matter of some 6 months ago, to return these moneys which were improperly charged against the Federal Government?

Ms. **Sweet**. I'm sorry, I was distracted a little bit. Could you repeat the question, please?

Mr. **Dingell**. The staff has expressed great curiosity on these matters. I must confess a modest level of curiosity of my own.

You found out about this in the Fall and you returned it 1½ or 2 weeks ago. What occasioned this long interval before conscience struck and you were compelled to return this money?

Ms. **Sweet**. It wasn't conscience that struck me.

Mr. **Dingell**. I beg your pardon?

Ms. **Sweet**. I'll just explain. Like I say, we have had thousands of requests by various auditors and when we responded to the question of the GAO, I would say it was approximately December on their Shopping Center question. We knew that the error had taken place.

It occurred to us within the past few weeks that we had not communicated that error to anyone other than the GAO. It was communicated to the GAO in the course of our response to their audit questions. We formalized that with DCAA and ONR and the GAO most recently.

Mr. Wyden, I have also been reminded of a specific example, if you would like to hear that, where we did voluntarily find something during the Fall, in spite of our heavy audit activities.

Mr. **Wyden**. If the Chair would just yield on that point; that to me is a key question because that goes to the ability to turn this mess around. If that's acceptable with the Chair, I'd very much like to hear it.

Ms. **Sweet**. OK, when we first found—when we finally found the Victoria, I should say, and the fact that depreciation had been charged incorrectly, we went back and we looked to see whether there was other similar kinds of equipment that was likewise charged. In fact, the Victoria was about less than a third of the amount that we withdrew.

The remainder was for other equipment that we found on our own by expanding the scope of the review.

Mr. **Wyden**. Mr. Chairman, if I could just continue; what other equipment was being charged, other boats?

Ms. **Sweet**. Our recollection is that there were some smaller boats, there was a computer, some golf course equipment. Like I say——

Mr. **Wyden**. Cars?

Ms. **Sweet**. Cars?

Mr. **Wyden**. Yes.

Ms. **Sweet**. To my knowledge, there were no cars.

Mr. **Wyden**. How many boats?

Ms. **Sweet**. I'm not sure of that.

Mr. **Wyden**. One, six, nine?

Ms. **Sweet**. I really don't know. I'll be glad to get that for you.

Mr. **Wyden**. Wouldn't that be relevant to the taxpayers, again, who would be listening to something like this? That's hard to see as a research expenditure. We're talking about it, and again——

Ms. **Sweet**. We agree.

Mr. **Wyden**. But you don't know how many boats.

Ms. **Sweet**. I must admit that I don't have the listing of all of the equipment. We went back and removed it all, every last item.

Mr. **Wyden**. But you don't know whether it's 5 or 10 or what?

Ms. **Sweet**. I really don't, Mr. Wyden. Like I say, we removed the entire amount and we can certainly get it for you, if you would like it.

Mr. **Dingell**. The Chair is going to express some curiosity here. You folks have been complaining here today about being Adam's Apple-deep in Government auditors who have been around requesting papers and asking for information and looking into all the events that are associated with this, and yet you come before us and express the greatest surprise that we are asking about boats and yachts and depreciation and when money was paid back and all these other questions.

I would assume that appearing here with the president, the controller and the assistant controller, there would be somebody there at the table who would have some vague appreciation of what the costs were, when the money was given back, why it was charged, what boats were depreciated, what were the other items and why all these events occurred and when the money was returned.

There's great surprise at the table when these questions are discussed. I'm not sure whether you were preparing for this hearing or for another hearing in another place on an entirely different subject.

The Chair recognizes the gentleman from Minnesota.

Mr. **Sikorski**. Thank you, Mr. Chairman. I have empathy for your situation and all of your professional careers and concerns and reputations of note and families and that, but I'm disappointed with the response, the formal response given. Mr. Keevan, on the last page, page 9 of your 9 and a quarter pages of testimony, you begin by saying, "The key test for reasonableness of costs such as linens and flowers and president's house are whether the costs are purely necessary for the overall operation of the university, despite the fact that they have no direct relationship to research. The major consideration involved in determining the reasonableness include whether the costs are consistent with the university's established policies and practices and whether the costs are prudent and are generally recognized as necessary for the operation of the institution, and it is my understanding that these types of costs meet these criteria."

I just walked out of here going to the vote and came back in and I don't think you get the point. I don't think you understand that this isn't a—if we catch you, then it's wrong, and that this is an issue of grayness. There are certain costs that were charged to the taxpayers that are simply not allowed and shouldn't be reimbursed.

That hasn't been admitted or stated, that I understand.

Mr. KEEVAN. Mr. Sikorski, I believe it has been.

Mr. SIKORSKI. OK, we'll take that, but every time we get into this issue again, we go back to this. The conclusion here that you cited for us is, you guys can either play around this gray area—this is your conclusion. These are not clear-cut questions; they're gray areas and if you want, we'll set up a very expensive system of accounting and then charge it back to you; end of discussion.

Mr. KEEVAN. I don't believe that's the proper interpretation of my conclusion.

Mr. SIKORSKI. I'm telling you whether it's the proper interpretation; I'm telling you it's my interpretation. Until this thing gets put into the perspective that I think most of the taxpayers watching this thing play out have, you're going to have trouble and a bunch of people are going to have trouble.

A little bit earlier, there was indignation that you had to respond for the last several weeks to a bunch of auditors. I know that's bothersome and isn't the way you'd like to conduct your business. I'm sure you're working 20 some hours a day and it's frightening and you have a pit in your stomach and the rest of it.

That's understandable, but that's nothing to get indignant about, because there remains at the end of this discussion, the issue that the gentleman from Oregon stated; it ultimately should play out that people say, this is a responsibility that we have and we need to be accountable and we pledge to do the best we can under that circumstance.

For me, I have respect for Stanford, but I don't have any connection; I didn't go there, I don't know anyone in my family that went there and the rest of it. There are a whole host of universities and research institutions across this country and the goose that lays the golden egg can be killed and made into pate unless this thing gets pulled in and people respond to these questions.

Dr. Kennedy, you know what I'm talking about. You've been through a lot of hearings and in Health and Environment and other places. You know how it works. I think people deserve an expression of concern.

Mr. KENNEDY. I know how it works, Mr. Sikorski, although I must say I've learned a little more. Let me just say that I think you're absolutely right about the need to respond, and I hope very much that you haven't detected indignation at this table about the presence of Government auditors. Look, we know that this is a legitimate inquiry, and we know that we have to answer the call and that we have to respond.

I do think, though, that it's a little unfair to charge us with unresponsiveness, as the Defense Contract Audit Agency has, when it has my controller's office in severe gridlock. We are really doing our best, I promise you.

Mr. **Sikorski**. Well, you know why that's occurring. We all know.

Mr. **Kennedy**. I understand.

Mr. **Sikorski**. The issue gets blown into headlines; there have been investigations, our investigation, GAO investigations. You get everyone breathing down your neck, you discharge it to other people, and DCAA needs to show that they're super investigators, and they go in, and everybody is making demands.

But this wouldn't have happened, none of this would have happened if there hadn't been a yacht, if there hadn't been a shopping center, if there hadn't been wine and linen and commodes and these other things. They're not the subcommittee's fault that that happened, and they're not the DCAA's fault that they happened.

The fault lies with the university and the Board of Trustees, and we get told that on linen and flowers of $2,000 a month, that the Stanford's Board of Trustees has confirmed that these types of cost meet these criteria.

I'm simply saying that I don't buy into the Board of Trustees' of Stanford's interpretation of anything. My responsibility goes to 650,000 people in the State of Minnesota and the Nation as a whole in some general way.

Mr. **Kennedy**. Well, I've tried to respond to that in my own assertions that we are going to work hard at this problem, Mr. Sikorski. We are determined to do that. I can assure you that Mr. Keevan shares my ambition to resolve these problems thoroughly, and that our attitude is that we want to create an excellent system.

Mr. **Sikorski**. Let me ask you on that. You had a shot to clean this thing up. When concerns first arose at Stanford, you conducted an internal investigation which concluded that the taxpayers of the United States owed you guys $13 million.

Mr. **Kennedy**. Mr. Sikorski, what I asked the internal audit to do was to examine some problems that Mr. Biddle had brought to our intention. That was not intended to be a comprehensive look, and the $13 million didn't come out of that estimate, it came from our estimates of the carry forward for years, I think, 1987, 1988 and 1989, or it may have been 1988, 1989 and 1990.

Mr. **Sikorski**. Do you think citizens of Blaine, Minn., feel happy that seven-eighths of the streets of Stanford are paid for by taxpayer money through an indirect cost program, a reimbursement for research?

Mr. **Kennedy**. Well, I certainly think they wouldn't be, and I wouldn't be, either, if they were. That number happens to be wrong, like some other numbers that came out.

Mr. **Sikorski**. How is that number wrong?

Mr. **Kennedy**. The actual allocation of capital construction of roads and so forth is about 39 percent, not 80.

Mr. **Sikorski**. OK. Four-tenths, assuming you're—I just don't—when the trustees approve linen and flowers at $2,000 a month, where does that money come from?

Mr. **Kennedy**. That money comes from the general fund of the university, or some of it, in some cases, from restricted accounts.

Mr. **Sikorski**. And then we pay that?

Mr. **Kennedy**. You pay that portion that's allocated to sponsored research from the G&A pool.

Mr. **Sikorski**. And our money comes out of?

Mr. **Kennedy**. The Government's money obviously comes from the taxpayers.

Mr. **Sikorski**. And the money spent on flowers at the house doesn't go to research elsewhere?

Mr. **Kennedy**. It is not a direct cost of research, and plainly, Mr. Sikorski, we agree with you because we are going to remove those costs, and we're going to see to it that they don't get in there.

Mr. **Sikorski**. Well, now, that's not what Mr. Keevan said. The school board, the trustees confirmed these types of costs meet the criteria.

Mr. **Keevan**. Mr. Sikorski, let me answer that, please. First of all, I do get the point. There are, however, indirect costs that are legitimate costs of running the president's house, and they are properly allowable. I'm not going to pick the numbers, I'm not going to pick the level of expenditure right now, but the fact is it takes something to run that house, and that house is there for the university.

Second, please, if I may finish, in terms of the indication that you apparently see here with respect to the DCAA and the GAO, we, in fact, instigated the coordinated audit activities that we've attempted to try to implement here at Stanford, and I participated actively in that because of the importance of getting this activity taken care of and behind us.

Third, I'd like to point out that apparently, there's been some statement by Mr. Biddle with respect to our university experience. It's pretty clear to me that this issue is a Government contracting issue, and a very difficult one.

I would also note to you that the day that I had the discussion with Mr. Biddle, he told me in front of DCAA representatives how absolutely pleased he was to have Arthur Andersen involved in this project because of high regard for the firm. As a result, I'm a little confused by Mr. Biddle's comments.

But I think we need to get moving. I just want you to understand I understand your point very well——

Mr. **Sikorski**. You have some background in it, and we should share that, if it hasn't been. You were associated with the Packard Commission.

Mr. **Keevan**. Yes, sir.

Mr. **Sikorski**. The Reagan administration attempt to ferret out waste and fraud and reform the procurement process at DOD.

Mr. **Keevan**. Yes, sir.

Mr. **Sikorski**. How do you view this situation from that experience?

Mr. **Keevan**. I view it as a disturbing situation.

Mr. **Sikorski**. OK. Thank you. Thank you, Mr. Chairman. Thank all of you. I know this is not pleasant.

Mr. **Dingell**. The Chair recognizes now the gentleman from Georgia.

Mr. **Rowland**. Thank you, Mr. Chairman. I have just a couple of questions I'd like to ask here, and I address this to you, Dr. Kennedy, or anyone there that can answer it.

The DCAA has found that an MOU concerning the utilities study is seriously flawed and has resulted in potentially significant overcharges by Stanford. For instance, the study purports that Government research uses 578 percent more electricity than research funded by Stanford. How has Stanford conducted its study regarding utility charges to support this existing MOU?

Mr. **Kennedy**. I'd like to refer that question to Ms. Sweet, who is in charge of our cost studies group, if I may. I just might say in more general terms that the utilities study is, like all other cost studies, done jointly with the Government and is the subject in this case, as you point out, of a Memorandum of Understanding that both the Government and Stanford have signed off on.

Ms. **Sweet**. I was a bit puzzled by some of the testimony I heard earlier. The utilities study was conducted by an outside engineering firm. Not only did the Office of Naval Research bring an engineer in—not their costing people, but an engineer in to work with us—but the Defense Contract Audit Agency was there and present and worked with us during the course of this study, too. So to the extent that there is now question about it, it's a bit of a puzzlement to us.

Now, we have agreed with the OCNR team that we will be conducting another utility study, and we're in the process now of putting together a proposal that will be presented to them next week on the conduct of a——

Mr. **Dingell**. Would the gentleman yield?

Mr. **Rowland**. Yes, I yield to the chairman.

Mr. **Dingell**. You're familiar with this utility study, are you, Ms. Sweet?

Ms. **Sweet**. Pretty much.

Mr. **Dingell**. Are you, Mr. Riddle?

Mr. **Riddle**. Fairly, yes.

Mr. **Dingell**. What was the premise on which it was decided that Government research uses 6.85 times more utilities than research funded by Stanford? Obviously, there is a reason. Why is it that Government research here uses 6.85 times more utilities than research funded by Stanford?

Ms. **Sweet**. I'm not familiar with that statistic. If someone could clear that——

Mr. **Dingell**. Well, you said you were familiar with the study. Mr. Riddle, can you assist us?

Mr. **Riddle**. No, I can't, sir, because I don't believe that number is in the study. I'm unfamiliar with that ratio.

Mr. **Dingell**. Well, supposing we dispensed with the figure which I have, which is 685 percent, and used 578 percent. Why is it that the Government uses more electrical and other utilities than does investigations and research that is carried forward by Stanford.

Mr. **Riddle**. Well, Mr. Chairman, you're obviously quoting from something.

Mr. **Dingell**. Pardon?

Mr. **Riddle**. You're obviously quoting from something that I'm not familiar with. If you could give us a copy——

Mr. **Dingell**. Well, you have a study which justifies this. There is an MOU, Memorandum of Understanding on this, and everybody has agreed.

Ms. **Sweet**. I certainly don't recall that from the study.

Mr. **Dingell**. Pardon?

Ms. **Sweet**. I certainly don't recall that from the study, so if you want to share with us what you're looking at, that would maybe help us.

Mr. **Dingell**. Well, Dr. Kennedy, you're the president, what can you tell us about this?

Mr. **Kennedy**. I can't tell you about this particular study, but I can offer a suggestion, if you just want—if you just want one off the top of my head. Government-sponsored research in general is research in the——

Mr. **Dingell**. Well, let me read to you what it says here. It says, The study adopted by the MOU concluded that the OR laboratory consumed 578 percent more electricity than laboratories for classroom instruction or department research. However, we identified meter readings and usage records as early as 1985 for electricity and 1986 for chilled water from SU's O&M Department. SU did not inform the Government of such records at the time of the 1985, 1987 and 1989 extensions. Also, SU did not correlate the results of the study to the meter readings and usage. Knowledgeable O&M personnel informed us that SU has meters and maintains records for utility consumption on practically all its buildings for access records for the utility reading and usage records.

Now, we have had testimony today that you have not been cooperative in making these records available to the GAO and to others. Can you give us some helpful comment on why Stanford has not been more forthcoming on matters of this sort.

Ms. **Sweet**. You're reading from a document that we have not been—that is not—we've never seen.

Mr. **Dingell**. This is a report to the committee from the Defense Contract Audit Agency.

Ms. **Sweet**. They did not share that with us.

Mr. **Dingell**. I'm just trying to reflect your recollection as best I might and hope that you might recall why it is that this situation occurs as it does? This MOU has been in place for 10 years. Obviously, there must be some familiarity on the part of some official at Stanford as to why Government is billed so much more for utilities than other research which takes place at Stanford.

Mr. **Rowland**. Mr. Chairman——

Mr. **Dingell**. I yield back the time to my friend.

Mr. **Rowland**. Let me just ask a question.

I thought that Ms. Sweet had earlier said that she was perplexed by this too, that she was aware of it but was perplexed by the charges.

Ms. **Sweet**. What I'm perplexed with is the fact that both—that DCAA, who participated with us during the conduct of the study, is now raising a question about it. That is what I was referring to earlier.

Mr. Rowland. So you are really not familiar with the situation about the overcharges relative to the electricity in the Government-funded research versus what Stanford is——

Ms. Sweet. The document that the chairman just read is not one that I am familiar with.

Mr. Rowland. Dr. Kennedy?

Mr. Kennedy. I thought I heard in what the chairman read, Dr. Rowland, that it was a comparison of the Government-sponsored research buildings with other buildings that were used for classrooms or non-sponsored research. Did I mishear that?

What was that sentence?

Mr. Dingell. If the gentleman would yield, it also said "and in department research."

Mr. Kennedy. Yes, well, it would not be——

Mr. Dingell. Just about everything you do.

Mr. Kennedy. Many of the pure science buildings that are occupied almost entirely by Government-sponsored research are very heavy utility users.

It would not surprise me at all if they were 10 times as heavy as classroom or departmental research buildings.

Mr. Rowland. If the chairman would yield back.

Mr. Dingell. It's the gentleman's time.

Mr. Rowland. Does that mean then that research goes on that is funded by the Government that uses, is your figure 10 times as much electricity as research that goes on that is funded by Stanford?

Mr. Kennedy. I think that the comparison was between those kinds of buildings, Dr. Rowland, and then other buildings that contained a mixture of things, and I thought I heard classrooms and departmental research and non-sponsored research. Perhaps the Chair could read it again.

Mr. Rowland. I'll yield.

Mr. Dingell. Doctor, if the Government is such a big energy user, why is it that this is carried as an overhead cost and why is it not carried—or rather, why is it not carried as I believe it more properly should as a direct cost of the research?

This is a large identifiable item.

You're carrying it as an indirect cost.

If you're going to run a cyclotron or you are going to run an atom-smasher or you're going to run high energy physics research or you're going to run big, powerful lasers, why is it that you don't charge this as a direct expense and a direct cost of the research as opposed to dealing with it as an overhead cost?

Mr. Kennedy. It could be done that way at no gain or loss to the Government.

The thing that we would need to have, Mr. Chairman, is a metering system that went by laboratory or activity rather than by building and that would——

Mr. Dingell. You have just told me that certain buildings were entirely Government research.

Mr. Kennedy. Yes, but——

Mr. Dingell. You have also indicated to me, rather I would think that if I were to ask you the question you would also indicate to me that where you do Government research, all the costs that are associated with Government research including energy costs are billed to the Government.

It sounds to me here like you were in fact billing the Government twice for the same energy and for the same utilities.

Mr. Kennedy. Oh, no, Mr. Chairman. We wouldn't bill the Government twice. I thought you were asking why we didn't in respect to buildings that contained only Government research direct charge it.

Those buildings contain many projects, so it would have to be direct charged to many different projects and we would have to have independent metering on all of them to justify the direct charge.

Mr. Dingell. Well, doesn't that go into your contract which you signed for the cost of the basic research which is done, as opposed to saying, well, we'll put it into overhead?

Mr. Kennedy. It might indeed be better to do it that way. It would not save the Government money, however. It would be the same amount.

Mr. Dingell. I am intruding into the time of the gentleman from Georgia and I am going to request the GAO to look at this particular point.

I thank the gentleman and I apologize for using your time.

Mr. Rowland. I guess the point is, Mr. Chairman, that the cost of electricity in this instance was used based on an MOU—a Memorandum of Understanding—and the question that you want answered—is it also being charged as a direct research expense.

Is that the——

Mr. Dingell. I think it is up to Dr. Kennedy to establish that that is not the way it is being done.

Mr. Kennedy. Yes, that's correct.

Mr. Rowland. That's correct, and I have just one other question, Mr. Chairman, that I would like to ask Dr. Kennedy, if I may.

Stanford last week wrote to the GAO acknowledging that the costs of Stanford's centennial celebration were included in the overhead pools at a cost in excess of $1 million and they now realized the real cost was not $1,074,523 but it was actually $420,311, a difference of almost $650,000.

It seems to be a rather large error. Do you have any idea how this occurred?

Mr. Kennedy. I do not, Dr. Rowland, but we can look at it and supply an answer for the record later.

Mr. Rowland. Well, this could well have been another accounting error, I suppose, and you'll just have to submit that, as you said, for the record.

How did you find this difference? Ms. Sweet?

Ms. Sweet. The one that you've just read?

Mr. Rowland. The one I just read.

Ms. Sweet. The one that you just read. The numbers that you have quoted are a bit different. They include not only the Centennial celebration but a collection of other accounts, so that the difference in the bottom line that you are dealing with is not just the

Centennial celebrations and I think that the record ought to be cleared up on that.

Mr. **Rowland**. But who brought this—even if it does include other costs—who brought it to your attention?

Ms. **Sweet**. The GAO asked a question regarding the Centennial and observing that they had heard a lot about the Centennial, and in response to questions relating to that, we discovered some errors on both sides, as a matter of fact.

Mr. **Rowland**. And so you really didn't know about this problem on your own but it was brought to your attention by the GAO?

Ms. **Sweet**. Correct. That's correct and we found in fact as we looked into it an error in the Government's favor and an error in the university's favor.

Mr. **Rowland**. Do we have any idea how many other problems there may be out there that the GAO is going to have to focus attention on and bring to light? Do you have any idea at all about that?

Ms. **Sweet**. You mean in terms of other errors?

Mr. **Rowland**. Yes, other errors, yes.

Ms. **Sweet**. Well, in an operation as large as ours, there are—there is opportunity for errors. There's no way to run an absolutely error-free system.

When we find them, we correct them.

Mr. **Rowland**. Well, we've talked about the internal controls that you have there and the fact that so many of these errors have occurred and have not been brought to light. So, it's puzzling why, as Mr. Riddle had said earlier, that you have a normal sort of accounting procedure in your university system, why it wouldn't have turned up these errors before someone else or some other agency brought them to your attention.

Mr. Chairman, I will yield back at this time.

Mr. **Dingell**. The Chair thanks you. The gentleman from Texas, Mr. Bryant.

Mr. **Bryant**. Thank you, Mr. Chairman.

Dr. Kennedy, I read your full statement and although I was involved in floor debate at the time you presented it, I have read it and I assume it's some of what you said in your direct testimony here.

I am puzzled about what your characterization of the cause of all of this problem is. Are you saying to the committee today that all of this has been an unfortunate and huge accident based only upon perhaps some sloppiness here and there in bookkeeping but there was no effort anywhere within the university to be aggressive, to put it mildly, in billing the Government?

Mr. **Kennedy**. I think we have three problems.

I think we have errors and an error level that I am certainly not comfortable with. We have some system infirmities which with the help of Arthur Andersen we are going to try to address and respond to aggressively.

Third, we have learned a hard and painful lesson about certain kinds of costs that under the rather complicated and perhaps in need of repair rules of OBM Circular A-21 are legally allowable but plainly inappropriate costs that in short should not be put in indirect cost pools.

I have tried to identify our responsibility for those errors and to testify to our willingness to move aggressively to correct them, so you don't see on this side of the table any sense of satisfaction about where we are but a lot of determination to get to someplace better.

Mr. **Bryant**. Well, what I hear, there is error and then there is the exercise of legal rights, which may not be in the spirit of what was intended by the law—is that what you are saying basically?

Mr. **Kennedy**. Yes, I think that is a fair characterization.

With respect to—with respect to the issue of aggressive recovery or over-recovery, I don't think we were particularly aggressive.

Had Stanford been distinctively more aggressive than other universities, I think the predicted result would be that we would have a rate that was here—an outlier—and then everybody else would have a significantly lower rate, and in fact there is a rather tight cluster of institutions.

Mr. **Bryant**. I am not trying to compare you to other universities. We are only looking at Stanford. I fear that this may indicate that other universities are doing as much or worse. I hope not.

You said that you were not being particularly aggressive. How then do you describe the way in which you did your accounting on the silverware?

Mr. **Kennedy**. Well, I don't believe that that was an intent to be aggressive, Mr. Bryant. I really don't. I think that that was an honest effort to value that fairly with an arms-length appraisal, transfer it as appropriate, and that the costs went into a pool was plainly inappropriate and that is obviously in that category of costs that we will withdraw.

Mr. **Bryant**. The dividing up of that silverware into pieces in order to make you eligible for more money, you don't see anything wrong with having done that?

You don't consider that even to be aggressive? I consider it to be blatantly dishonest, but I'm surprised you wouldn't at least concede that it is aggressive?

Mr. **Kennedy**. Mr. Bryant, that assumes that it was done for that purpose and I'm not aware that it was done for that purpose.

Mr. **Bryant**. What other purpose could it possibly have been done for?

Mr. **Kennedy**. Well, I haven't examined the transaction in detail, Mr. Bryant, but——

Mr. **Bryant**. But you have heard as much about it as I have. What purpose could it possibly have been done for except to get more money?

Mr. **Kennedy**. I think that the silverware came in different categories and it was probably appraised in the categories that it came in and I suspect that it was not, that the value for each didn't exceed the threshold.

I think that to assume aggressive intent is more than the data suggests at this point but we will certainly ask about it.

Mr. **Bryant**. Have you not asked about it before today?

Mr. **Kennedy**. Well, I haven't asked about the way in which the appraisal was obtained, no. I haven't.

Mr. **Bryant**. Why not?

You said earlier today in response to a question from the chairman that you couldn't assign intent. You didn't know how to assign intent with regard to this matter.

The question in my mind at the time was why didn't you call somebody and ask them what happened?

Mr. **Kennedy**. It didn't occur to me that suspicions would arise about the intent.

Mr. **Bryant**. Didn't any suspicions arise in your mind about the intent? That's what I am getting at.

Mr. **Kennedy**. No. It seems to me that given that the way that that material comes, that it is in lots, that it was reasonable to appraise it in lots, so no, I didn't feel suspicious about it.

Mr. **Bryant**. I want to tell you, my heart sinks to hear you saying that, because I can't believe you believe it. I mean, it is really disappointing that you cannot acknowledge that there was something that could at the very least be called aggressive going on with regard to that silverware.

Let me ask you, how often do you see the controller and the assistant controller?

Mr. **Kennedy**. Well, I certainly see them at least weekly in various meetings and in various connections.

Mr. **Bryant**. Have you never asked them about intent with regard to this silverware?

Mr. **Kennedy**. With regard to the silverware, no.

Mr. **Bryant**. No? Interesting.

Mr. **Dingell**. I am curious to know—would the gentleman yield?

Mr. **Bryant**. Sure.

Mr. **Dingell**. Didn't you, Ms. Sweet, and you, Dr. Kennedy, and you, Mr. Riddle, inform this committee earlier that this silver came as a part of a house which was left to the university?

It didn't come in a package. It came in a whole house. You didn't get it in bits and pieces or neatly wrapped packages; you got it in a house. Now am I right or wrong? And which statement by you good ladies and gentlemen are we to believe, your first or your second?

Mr. **Kennedy**. Mr. Chairman, I don't see any inconsistency. I simply said that——

Mr. **Dingell**. You either got it in a house or you got it in separate packages.

Mr. **Kennedy**. The silver was not in one lump.

Mr. **Dingell**. Which way did you get it?

Mr. **Kennedy**. It came as part of a house, part of the furnishings of the house.

Mr. **Dingell**. But it didn't come in bits and pieces, and it didn't come in neatly-wrapped packages, separate and identifiable, did it?

Mr. **Kennedy**. Well, I don't know what form it was in, in the house. Part of it may have been stored one place, part another, some was knives, forks, and spoons, some was platters. I don't know.

Mr. **Dingell**. But you have driven us, Dr. Kennedy, you and Ms. Sweet and Mr. Riddle, to the somewhat curious view that just perhaps this was left to the university in packages which were less than $500 lots. But you have also told us it came as a part of a house, and to the extent that it didn't come in neatly-wrapped $500 packages, which would enable you to expense it as opposed to depreciating it.

I yield back to my good friend.

Mr. **Bryant**. I would just say, Dr. Kennedy, it is really disappointing for me to see a university president, particularly one of such a fine institution, stonewalling this committee like a common politician. That is very disappointing. Where are we to look for examples in leadership?

Mr. **Kennedy**. Mr. Bryant, I have the list of appraisals. I am seeing it for the first time——

Mr. **Bryant**. And why are you seeing it for the first time? That's my question.

Mr. **Kennedy**. This was plainly done item by—because I didn't get nearly as interested in it as you have gotten me this afternoon.

Mr. **Bryant**. Would you let us have a copy of that?

Mr. **Kennedy**. You bet.

Mr. **Bryant**. We'll send someone down to get it.

In the meantime, I would like to ask a question of Mr. Riddle. Mr. Riddle, you are the controller of the university, is that correct?

Mr. **Riddle**. That is correct, sir.

Mr. **Bryant**. How come you didn't know that there was a yacht in the university's portfolio of assets?

Mr. **Riddle**. It never came to my attention that there was a yacht.

Mr. **Bryant**. Now are you testifying here today under oath that you did not know at the time that these Government officials came to see you, that there was a yacht owned by the university?

Mr. **Riddle**. I am.

Mr. **Bryant**. And Ms. Sweet, are you testifying the same?

Ms. **Sweet**. That's correct.

Mr. **Bryant**. Isn't it fair for us to be suspicious about that? I mean how could you not know if you're supposed to know about all the assets of the university, that you owned a yacht? How could you not know that?

Mr. **Riddle**. Well, Mr. Bryant, as I have testified earlier, the university is a $1.2 billion enterprise. We have about three million transactions a year that flow through our accounting system. And no, I don't review every one of them. I was not in this particular transaction, and I did not know about the yacht until after it was brought to our attention.

Mr. **Bryant**. Who brought it to your attention?

Mr. **Riddle**. I believe the first I heard of it was from the staff of this committee.

Mr. **Bryant**. Well, that would seem to me curious as well. It's a 72-foot luxury yacht outfitted with wood stoves and a Jacuzzi. And after you admitted you owned it, you then denied that you had charged any of the costs of it to the Government. Is that correct?

Mr. **Riddle**. That is in the series, yes, series of happenings. We first said we did not have one, and I believed that to be true. I then discovered that it was in the sailing club which is part of an auxiliary activity, as has been testified to by GAO, and that is true. And as an asset of an auxiliary, I believed that it would not be depreciated to Federal research.

I later found out that there was a glitch in the accounting system, and that accounting error allowed it, along with other items, to be accumulated in a cost pool. That glitch has been fixed. It's totally an embarrassment. It was wrong, it was totally wrong. However, it did happen.

Mr. BRYANT. Well, we must take you at your word for that, I think, although it's strange to me that you never come up with any recognition of where you stand until after the subcommittee begins to delve into it and show you facts.

Let me observe another embarrassment. I'm looking at the document that the president of the university just sent up to the desk up here. In order to fit this silverware into the categories necessary to get more money out of the Government, you had to divide it up into dinner knives, categories such as follows: dinner knives, dinner forks, luncheon and dessert forks, spreaders—I guess that's for butter—salad forks, teaspoons—these are categories. And there's a value placed next to each of these categories out to the right which keeps the total values under $500. And this is the way in which Stanford University managed to get more money out of the U.S. taxpayer.

Mr. KENNEDY. Mr. Bryant, the appraiser, like most appraisers, works by categories. I am not aware that the appraiser received any instructions from Stanford as to how to operate in this case. If we discover that he did, we will certainly let you know. But it is my presumption that the appraiser worked in the way appraisers choose to work.

Mr. BRYANT. Look, if you came in here and said, "Look, we have been too aggressive, this has not been the right thing to do, we were pursuing funds according to the way other universities do it. We thought we should have done it this way; it's wrong, we're not going to do it any more," I'd say, "OK, well, let's move on to something else."

But your refusal to acknowledge that you are even aggressive in seeking these dollars is very, very disappointing, extremely disappointing, and I frankly find it impossible not to conclude that there was an intentional effort on the part of somebody at Stanford University—and I think the president has to take the responsibility for it—to get more money out of the taxpayer than your university deserved.

I yield back my time.

Mr. DINGELL. The time of the gentleman has expired.

Doctor, we have found that we seem to have a major accounting and communications problem here. I am curious. You have hired a splendid and respected panel of legal counsel, for whom I have the utmost respect; you have hired an outstanding public relations firm; you have hired one of the outstanding accounting firms. In a meeting with subcommittee staff on Wednesday, January 23, your counsel assured the staff that the charges for these services would not be placed in any overhead account.

More recently, your vice president for public affairs was quoted as saying that the university hasn't decided whether the costs for the Mankowitz PR firm and the lawyers would be charged to research overhead.

Where are these charges going to go? Here we have had you before us to explain why you have been charging all these moneys, how much you have charged, whether it's proper, and how much you are going to give back. And the question is, is the Government going to pay for that privilege, or is the university going to pay for that privilege?

Mr. **Kennedy**. Mr. Chairman, I have a strong instinct for self-preservation, and I think you may be sure that none of these costs will appear in any pools that are allocated, even in part, to sponsored research. Thank you.

Mr. **Dingell**. Well, Dr. Kennedy, we have kept you here a long time. There are bells on the floor. The members, I know, have other questions.

We are profoundly distressed. You come from a great and deservedly respected institution. There have been serious questions raised which the committee has found to be very distressing about the expenditures of public moneys.

The committee is basically driven to choose between three options: one is that there is great incompetence out there; one is that there is rascality out there; and one is that there may be both.

We intend to review this record with considerable diligence to find which conclusion the committee is to be driven to.

The events of today have not been pleasant to you, nor have they been pleasant to the committee. The events of today, however, have not reflected well upon the university or upon you or upon those who appear here in attendance with you.

The charges made have dissipated enormous sums of money which would have been better used for either paying the cost of other government activities, or going into other research activities to benefit the society generally.

It appears that there was great carelessness, in the most charitable interpretation, in the expenditure of these funds. My hope is that the ongoing investigation here—and it is not ending when the gavel falls—will assist you in perfecting your approach.

Clearly it is not satisfactory to me as the chairman of this subcommittee, or to my colleagues on the committee, when we hear you say, "We don't know, we haven't heard, we will have to look into that, this is new information."

You had here the controller and the assistant controller of the university. We assume they know something about controlling a university. Regrettably, we are driven to a different conclusion.

We find that there has been great preference conferred upon other donors for the purposes of research. The government of Japan, one of the most wealthy in the world, which is known for its failure to contribute its fair share to things like Desert Shield and Desert Storm, has been a great recipient of the charity of your university, which was at least indirectly a contributor of funds which were given to your university for the carrying out of research.

The record today does you and the university no credit. It is my hope that as the committee continues its inquiry into these matters, you will correct the complaints and the concerns that the committee has heard today.

I do wish you to know that we are not concluding with the banging of the gavel today the inquiries of the committee. We are going to also be inquiring into other universities. We are going to be inquiring into the behavior of the Government, which has been making this kind of unfortunate hearing not only possible but necessary. And we are going to try and see to it that a process is set up where this kind of abuse will not occur again, and will not be inquired into again by this committee. But until that has been accomplished, the committee intends to pursue these matters with slightly more than normal diligence.

We thank you for your presence today. The committee stands adjourned until the call of the Chair.

[Whereupon, at 5:08 p.m., the subcommittee was adjourned, to reconvene at the call of the Chair.]

[The following documents were submitted by Stanford University. Certain other supporting documents are retained in the subcommittee files.]

STANFORD
CENTENNIAL

May 20, 1991

Mr. Bruce Chafin
Subcommittee on Oversight and Investigations
Committee on Energy and Commerce
United States House of Representatives
Washington, DC 20515

Dear Mr. Chafin:

Stanford University submits for the record the following enclosed items related to matters raised at the hearing conducted on March 13, 1991. We request that the items below, except for specifically indicated bulky supporting material, be included in the printed record. (We have photocopied the items that should be included in the record, and enclosed those copies as a seperate packet.)

1. A list of corrections to a draft copy of the transcript of the hearing (SU000387-389). We request that these corrections be reflected in the text where the comments appear.
2. A detailed report of waivers of indirect costs for fiscal years 1989 and 1990 (SU000390-407). This report, prepared by our Dean of Research, sets forth Stanford's policy and procedures with respect to indirect cost waivers. It also includes an explanation for each project for which indirect costs have been waived. Two points ought to be noted because they are often overlooked: 1) Waivers are granted to federal projects as well as to projects sponsored by others; and 2) In all cases, waived costs are never passed on to other research sponsors but are paid for by University funds which derive from tuition, endowment income, and donated funds. Specifically, this means that the federal government is not charged for these waived costs either during the year incurred or in future years. We request that Dean Byer's introductory memorandum and the eleven pages of the text of the report, plus the four tables immediately following page 11, be included in the printed record. The tabbed attachments A-G, which consist of supporting documents, should be referenced but not included.
3. Two volumes of documents, each with explanatory introduction, demonstrating the extensive involvement of DCAA in the development of Memoranda of Understanding in the 1980s (SU000408-417) and Stanford's active efforts to seek audits from DCAA (SU000418-422). We request that the introductory text sections of each of these volumes be included in the printed record, but we believe that the bulky supporting documentation should be referenced but not included.

Stanford University • Office of Public Affairs • Building 170 • Stanford, CA 94305 • 415/723-2862

4. A letter to ONR, dated April 19, summarizing costs that were voluntarily withdrawn prior to the March 13 hearing; appended to this letter are copies of letters notifying the government of the withdrawals and of repayment by the normal, accepted method of crediting the carryforward (SU000423-440). Also included is a copy of a letter accompanying the repayment of these withdrawals by check as requested by the government after the hearing (SU000441-442).

5. Two affidavits related to the silver transaction that received attention at the March 13 hearing (SU000443-452). These two affidavits — one by the appraiser of the silver and one by the staff person who entered the transaction into the books — show that each of these persons handled their part in the silver transaction according to their professional judgements, without any instructions from Stanford (in the case of the independent appraiser) or superiors (in the case of the Stanford employee) and that the possible impact of the transaction on indirect cost reimbursement was not a factor in their handling of the transaction.

6. Documents showing the return and subsequent credit related to two urns which were specifically mentioned at the March 13 hearing (SU000453-455).

7. An explanation of the treatment of costs related to Stanford's Centennial (SU000456-459).

If you have any questions about any of these items, please let us know. We are most eager to work with the Subcommittee and to cooperate fully with all government inquiries.

We know of the Subcommittee's continued interest in indirect cost issues. As you know, there is much activity now underway at Stanford: We are working simultaneously to clear up outstanding issues related to the open years and to institute internal reforms. Within the next few weeks, Arthur Andersen is expected to complete its review of Stanford's internal controls and to present recommendations. We, in turn, will seek the advice of our outside Advisory Panel on implementation of these recommendations. We will report to you on these matters as they are completed, and we will be glad to answer any questions you may have.

I request that this letter also be included in the printed record.

Sincerely,

Larry N. Horton
Associate Vice President
for Public Affairs

Enclosures

RESPONSE TO QUESTIONS ABOUT UTILITY STUDY RAISED AT MARCH 13, 1991 HEARING

In the hearing, Mr. Rowland raised a question about the Utility Study conducted for Stanford which, he indicated, showed Government research "uses 578 percent more electricity than research funded by Stanford" (Testimony Transcript page 285.) Chairman Dingell read from a report to the Committee from DCAA stating that the "study adopted by the MoU concluded that the OR [organized research] laboratory consumed 578 percent more electricity than laboratories for classroom instruction or department research" (Transcript, p. 288). That statement from DCAA is simply incorrect.

The Utility Study establishes weighting factors for utilities. Classrooms are weighted at 1.00. Relative to classrooms, electricity consumption for laboratories used for instruction and department research (class laboratories) are weighted at 1.22 and organized research laboratories (which include laboratories that do government sponsored research) are weighted at 3.04. On an aggregate basis, electricity for a square foot of organized research laboratory space is 1.49 times higher than laboratories for instruction or department research.

Organized research laboratories consume more electricity per square foot than laboratories used for instruction and department research due to their being in use more hours during the week, thereby needing to be heated/cooled/ventilated more hours per square foot. In addition, some organized research laboratories have "clean rooms" or special animal rooms with very specific requirements for costly ventilation, air filtering and air handling. Organized research laboratories also contain more equipment, such as lasers, autoclaves and accelerators, which consume more electricity per square foot than laboratories used for classroom instruction and department research.

Robert L. Byer

Dean of Research
Professor Applied Physics
Stanford University
Stanford, California 94305

May 6, 1991

To: Donald Kennedy, President

From: Robert L. Byer, Dean of Research

Subject: Report on Indirect Cost Waivers for FY 89 and FY 90

Dear Don,

Enclosed is the report on indirect cost waivers for all sponsored project expenditures, including both instruction and research, for fiscal years 1989 and 1990, in which external sponsors did not fully fund the indirect cost reimbursement at the rates negotiated with the federal government. In each of the two years, indirect costs not funded by external sponsors amounted to about $16 million which represents about 15% of the total indirect cost expenditures of $104 to $110 million for each of those years.

Although referred to as "waived" or "foregone" costs, these costs are funded by the University's general funds which are acquired through student tuition, endowment income and gifts to the University. Indirect costs not funded by external sponsors are never passed on to other sponsors. In particular, the Federal Government is not charged foregone indirect costs either during the year incurred or in future years. Waived indirect costs represent Stanford's contribution to instruction, research, and public service projects which otherwise might not be funded.

The majority of projects which do not carry full indirect cost reimbursement are those funded by federal, state and local governments, and nonprofit foundations. Only a small number of projects are funded by corporations or foreign governments and the majority of these involve clinical trials.

Of 3000 projects, about 900 projects per year carry less than the federally negotiated full indirect cost rate. A significant number of those projects are for the purpose of training students, conducting conferences, supporting junior faculty such as the 46 Presidential Young Investigators at Stanford under the National Science Foundation program, public service events or other small projects in disciplines not usually funded by external sponsors. Of the $16 million in foregone indirect cost reimbursements, about 25% or one fourth of the costs are for projects funded by the Federal Government, 61% to 64% are for the costs of projects funded by other U. S. non-profit agencies, and around 8% are for the costs of projects funded by state and local governments, and only 4% represent costs for projects funded by foreign or U. S. corporations.

I believe that the data presented in this report are accurate. I apologize for the format of the detailed list of accounts as they could not be reformated for reading ease. However, I believe that it important to provide all of the relevant information as soon as possible. I will be glad to answer questions that arise regarding our policy on indirect cost reimbursement at Stanford University or questions about individual projects.

Robert L. Byer

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Waivers on Indirect Cost Recovery at Stanford University for Fiscal Years 1989 and 1990

This report summarizes foregone indirect cost recovery on externally-sponsored project expenditures at Stanford for the University's Fiscal Years 1989 and 1990. It has been prepared in response to questions raised by Congressman Dingell at a recent hearing of the Oversight and Investigations Subcommittee of the House Energy and Commerce Committee. For purposes of this report, "foregone indirect cost recovery" refers to those awards for which the external sponsor paid lower indirect costs than those negotiated between the government and Stanford.

I. INDIRECT COST RATES

At any given time Stanford has about 3000 externally-funded projects underway which are formally categorized as "sponsored research," "sponsored instruction," or "other sponsored activities" (e.g., conferences, exhibits, travel grants, etc.) The University has negotiated with the federal government different indirect cost rates for each of these categories of projects. ATTACHMENT A provides a list of the indirect cost rates applicable to each of these categories of sponsored projects from FY85 through FY90.

Not included in that list, nor discussed further in this report, are indirect cost rates used for projects sponsored by corporate and foreign agencies during the 1980's. In all cases those rates were higher than the government-negotiated rates. By the end of FY89 those higher rates were eliminated. Since then only the government-negotiated rates have been used at Stanford, regardless of sponsor type.

II. INDIRECT COST RECOVERY FOREGONE BY STANFORD IN FY89 AND FY90

Had the University fully recovered indirect costs on all sponsored project expenditures from external sponsors based on government-negotiated rates, a total of almost $104 million in FY89 and $110 million in FY90 would have been reimbursed to Stanford for indirect cost expenditures in those years. However, about $16 million of those totals each year was in fact funded by the University rather than the project sponsor. That is, although referred to as "foregone" or "waived" costs, they are in fact real costs that are incurred by those projects and which Stanford must pay when the sponsor does not. These "foregone" costs never are passed on to any external sponsors, either during the year they are incurred or in future years. They are funded entirely by University funds acquired primarily through student tuition, gifts, and endowment income.

Stanford's purpose in waiving indirect cost recovery on selected projects reflects the University's commitment to public service by cost sharing on those projects. For example, if the University refused to ever engage in any externally-funded project with less than full indirect cost recovery, the following opportunities for Stanford to serve the public good would have been lost because of the funding agencies' refusal to pay full indirect costs: research projects funded by USDA grants or cooperative agreements; California state-funded AIDS or Alzheimer research; international assistance projects funded by the World Bank, NATO, or the World Health Organization; or health research funded by the American Cancer Society or American Heart Association.

Of the total dollar amounts foregone in each of the past two years (i.e., funded by Stanford), about 95% of the amounts waived were for non-profit or non-foreign government entities: about 62 % was in support of projects whose direct costs were funded by US non-profit agencies (such as the Ford Foundation, American Cancer Society, Muscular Dystrophy Association, etc.); about 25% was for projects funded by the U.S. Government; around 8% was for projects funded by state and local governments; and around 4% was for US corporate and foreign sponsors combined (see ATTACHMENTS F and G, which show these data in both summary and detailed forms for FY89 and FY90).

It is important to note that the University is able to waive these amounts -- and hence fund a portion of the award itself through University funds -- for only a small portion of all indirect cost expenditures. The University could not afford to waive recovery of a large portion of its indirect cost.

III. REASONS FOR REQUESTING INDIRECT COST WAIVERS AND THE PROCESS FOR GRANTING THEM

In any given year approximately 95% of the total foregone indirect cost recovery is due to the sponsors' refusal to pay the full overhead rate. However, requests for waivers, regardless of the reason, are not automatically granted by Stanford. Indirect cost waiver requests are initiated by the individual faculty member who wishes to submit his/her proposal to an external agency. The request must be in writing and must indicate why a waiver is justified. Reasons for the granting of waivers include the following:

- Most frequently the reason given is that the funding agency will not pay the full overhead and the faculty member cannot find support for the proposed project from other sources;

- The funding agency is funding a "bottom line" and the faculty member cannot accomplish the goals of his/her research with the remaining direct costs if full indirect costs are applied;

- The funding is solely for the purpose of supporting a graduate student research assistant for whom other sources of support cannot be identified;

- The funding amount represents a "seed" grant for a small pilot project, which, if its results are promising, will lead to follow-on funding for a full-fledged project which would then carry the full indirect costs.

The faculty member's request for a waiver is subject to the review and approval of the relevant department chair, school dean, and in some cases, by the Dean of Research office (see ATTACHMENT C, which is an excerpt from Stanford's Research Policy Handbook outlining the procedures to be used when seeking an indirect cost waiver.)

IV. FACTORS CONSIDERED IN GRANTING INDIRECT COST WAIVERS

The following factors influence a decision to accept a project with less than full indirect cost funding:

- Most important is the amount of the requested waiver, as Stanford must fund from University sources all indirect costs foregone from the sponsor. Indeed, the average size (direct costs) of a project involving an indirect cost waiver is considerably smaller than the average size of the direct costs of projects carrying full overhead. Waived indirect cost reimbursement cannot, of course, be passed on to other research sponsors, and the University could not afford to waive reimbursement on a majority of the awards it receives.

- The importance of the proposed project to that faculty member and his/her department's overall teaching and research program also are major considerations. This includes special hardship situations such as the need to find support for graduate students between periods of other external funding.

- Special consideration is given to the needs of junior faculty to help them establish their research careers. Many projects involving waivers are in support of young investigators under such programs as NSF's Presidential Young Investigators and Searle Scholar Awards.

- The nature and subject matter of the project also are significant considerations. Waiver requests are much more likely to be approved if they are in subject areas where funding opportunities are rare, such as humanities or social sciences. Consideration also is given to public service programs that help promote the University's goals of affirmative action (such as the U.S.-funded Upward Bound project) or community and student service projects (such as state-funded public events or development of international studies curriculum materials to be taught to school children in grades K-12).

- Another factor is the consistency with which the funding agency applies the indirect cost limitations to all awardees. The University must be assured that the sponsor is treating all grant recipients in an equitable manner. (See ATTACHMENT B for list of federal and state programs and U.S. nonprofit sponsors to which proposals may be submitted for less than full indirect cost recovery without case-by-case review by the Dean of Research Office.)

- The nature of the funding agency is of prime importance: waivers are very seldom granted in cases involving either profit-making or foreign sponsors. Each such request must be reviewed on a case-by-case basis in the Dean of Research office and approvals are granted only for the most compelling reasons.

V. INDIRECT COST WAIVERS ON FOREIGN- OR CORPORATE- SPONSORED PROJECTS

Because waivers for foreign or corporate sponsors may raise particular concern, below is a discussion of every foreign- or corporate-sponsored project for which expenditures were made in either FY89 or FY90 involving indirect cost waivers from rates less than those established with the federal government.

A. FOREIGN-SPONSORED PROJECTS

Although the enclosed summaries and detailed printouts indicate nine projects in FY89 and six projects in FY90 involving waivers for foreign sponsors, there were a total of only ten projects, as five had expenditures in both years. Each of these projects are listed in the detailed summaries enclosed on page 64 of ATTACHMENT F and page 68 of ATTACHMENT G. A description of the projects and reasons for the waivers are summarized below:

1) Canadian Consulate (project title: Interdependence in North American, A Tri-national Project.) This was a study of the interdependence of the U.S., Canada, and Mexico, a subject matter of great interest to a new Stanford Program on the

Americas. The waiver was approved to help start the program, given that it is extremely difficult to obtain US government funding for social science projects of this nature. Other considerations included the fact that the Canadian government would not fund indirect costs to an American University and the total amount waived was small.
Total foregone indirect costs for FY89 and FY90: $6,000.

2) Japan Government (project title: Japan Consulate Grant.) This is a long-standing sponsored instruction project to develop curriculum materials and teacher training programs for U.S. school children in grades K-12 to learn more about international issues, with particular emphasis on Japan. This project is undertaken as a public service to our public school system, with the results disseminated throughout elementary and secondary schools in California. As the Japanese government would not pay indirect costs on this project which benefits Americans, Stanford agreed to fund the indirect costs as a University contribution to California's educational system.
Total foregone indirect costs for FY89 and FY90: $43,000

3) Pro Helvetia (project title: Visiting Professorship of Swiss Studies.) This Swiss sponsor funded the full costs of a visiting professor's salary while at Stanford. The teaching and research conducted by the visiting faculty member represents a significant intellectual benefit to the University as well as salary savings, which otherwise would have had to be paid from Stanford's General Funds. The amount foregone in this case constituted indirects associated only with a small amount of direct funding the sponsor provided to cover incidental supplies and materials for the professor while at Stanford.
Total foregone indirect costs in FY89 and FY90 combined: $9,000

4) Indonesia (project title: Food Policy and Rural Income Generation): This was a project of international assistance to help the government of Indonesia assess the impact on income and employment in rural areas of different agricultural technologies and policies on food prices and production. Other international organizations also participated in the study, which was also of benefit to other developing countries. The indirect cost waiver was granted to permit the maximum funding possible to be used for the direct costs of the project.
Total foregone indirect costs in FY89: $53,000

5) Ebert Stiftung (Foundation) (project title: Technology Project in the Americas: An International Symposium.) This project was an international conference to discuss the impact of new information technologies on economic relations between North and South, particularly among Canada, the United States and Latin America. The funding agency was a West German non-profit foundation which declined to fund indirect costs. Stanford agreed to fund those costs as the symposium was a featured event in the University's Centennial activities.
Forgone indirect costs in FY89: $5,000.

6) Weizmann Institute. The remaining projects funded in either FY89 or FY90 by foreign sponsors constituted five student fellowships awarded by the Weizmann Institute of Israel, of which three extended over both FY89 and FY90. In addition to the direct costs of the fellowships (which are not subject to indirect costs under normal University policy) there were modest allowances ranging from $100 to $1,225 for the fellows' supplies and materials. Indirect costs were waived on those allowances in order to maximize the small amounts of funds available to the students.
Total foregone indirect costs for FY89 and FY90: $5,000.

B. CORPORATE-SPONSORED PROJECTS

Excluding Clinical Trials, which will be discussed later, Stanford had expenditures on 12 corporate-sponsored projects in FY89 and FY90 which involved indirect cost waivers (four of which had expenditures in both FY89 and FY90). These are listed in ATTACHMENT F on page 63 and in ATTACHMENT G on page 67. Below is a brief description of each project, the reason for the indirect cost waiver and dollar amounts foregone.

1) Bristol-Myers (no project title listed/Weissman.) This was a fellowship grant for a student. Although the stipend for the student does not incur indirect cost charges (per normal University policy), Bristol-Myers provided an extra $3,500 over the two years for the fellow's research materials and supplies which ordinarily should bear overhead. The indirect costs were waived in this case to maximize the small amount of funds available to the student.
Total foregone indirect costs in FY89 and FY90: $2,000

2) Merck,Sharp, Dohme Labs (project title: Regulation Enzymes...): This was an account last funded in 1980 with the remaining money available for the faculty member's unrestricted research purposes. It has been used to support students.
Total foregone indirect costs in FY89: $119

3) Standard Oil (project title: Development and Integration of Techniques for Forecasting of Reservoir Behavior) This was intended by the sponsor to be a corporate contribution to a general field of forecasting the characteristics of reservoirs. Due to some last-minute sponsor restrictions on the use of the award, it had to be categorized as a sponsored research project, for which indirect costs normally are charged. Because of confusion at the time the award was made, indirect costs were waived on this donation.
Total foregone indirect costs in FY89: $12,000

4, 5, 6) General Electric (3 projects: NMR Clinical Research Agreement, Digital Radiography, and Improved MRI Systems) These three projects funded by GE were granted partial indirect cost waivers down to the Clinical Trial rates in recognition of GE's multi-million dollar equipment donations which accompanied the funding they provided for research on magnetic resonance imaging used for the diagnosis of

human diseases and injuries. In particular, GE replaced without charge a piece of instrumentation estimated at $1M they had initially donated which was damaged in the 1989 earthquake. They did fund indirect costs over this period in the amount of $167,000. GE's equipment contribution far exceeded the foregone indirects which were funded by Stanford.
Total foregone indirect costs for all three projects in FY89 & FY90: $146,000

7) IBM (project title: SSRL Beam Line II Modification.) This was a facility improvement grant, covering costs associated with enhancement of the Stanford Synchrotron Radiation Laboratory's (SSRL) instrumentation. SSRL, funded primarily by the U.S. Department of Energy, is a national resource used by some 500 researchers from government labs, universities, research institutes and companies throughout the world. Stanford agreed to fund the indirect costs on this facility improvement project in recognition of SSRL as a national resource.
Total foregone indirect costs in FY89: $40,000.

8) Boehringer Ingelheim (fellowship project untitled.) This was a student fellowship award which was accompanied by a small allowance for the fellow. Indirect costs were waived on this allowance so as to maximize the resources available to the student.
Total foregone indirect costs in FY90: $1,000.

9, 10, 11) Apple Computer, Advanced TV Test Center, and U.S. West Advanced Technologies (3 separate projects: Interactive Multi-media Program, Viewer Response to "Leterbox" format..., and the Computer as a Social Actor...). These projects were all social science studies addressing the ways humans react to information transmitted by television and/or computers. The Apple-funded project was to develop an interactive audio-visual program involving computers and other media to help students learn more about the human circulatory systems. The Advanced TV Test Center-funded project was a study of computer users' understanding of and reactions to information, depending on the way it is displayed on television. The third project (US West) was a study of the social process of human-computer interactions for the purpose of learning more about users' reactions to and expectations of computers. These studies were conducted in the departments of Communication and Education. The sponsoring agencies refused to pay full overhead and Stanford agreed to the waivers given the potential educational benefits to be derived, the small size of the dollar foregone, and the fact that the disciplines involved have few external research funding opportunities.
Total foregone indirect costs on all three projects in FY90: $29,000.

12) General Motors (project title: Design and Construction of High-Performance...Robot System.) This was a project in Mechanical Engineering intended by both Stanford and General Motors to be a corporate grant without restrictions as to specific use of the funds or reporting requirements to the donor. However, due to administrative error, the award was negotiated instead as a formal contractual agreement, which normally should be subject to indirect costs. Because

of the misunderstanding involved, Stanford agreed to fund the indirect costs involved in the project.
Total foregone indirect costs in FY90: $23,000.

C. CLINICAL TRIALS

Clinical Trials are a subset of sponsored research projects which are discussed in detail in ATTACHMENTS F AND G. Although formally these projects are considered as sponsored research and therefore potentially subject to the University's off-campus sponsored research indirect cost rate, clinical trials are in fact charged to a special lower rate set by the Medical School which is applied uniformly to all clinical trials, including those funded by the federal government.

As noted on page 60 of ATTACHMENT G, there were two projects (Hoffman-Laroche and Pfizer) categorized as Clinical Trials which show indirect cost waivers for FY90 (and, in the case of Pfizer, FY89). These accounts were funded many years ago as unrestricted donations for the general research support of the involved faculty members. The Hoffman Laroche account was last funded in 1980 and the Pfizer account was last funded in 1977. Indirect costs were not charged to those expenditures, in accordance to normal University policy regarding donations, but these accounts were miscoded and thus appear in expenditure reports as "clinical trials" due to administrative error. (See also Attachment E for a discussion of Clinical Trials.)
Total foregone indirect costs reported in error in FY89 and FY90: $14,000

VI. INDIRECT COSTS ON SPECIFIC PROJECTS QUESTIONED BY CONGRESS

In the course of the recent Congressional hearing, concerns were raised that Stanford was "subsidizing" several foreign or profit-making entities by not charging our full indirect cost rates to projects they sponsored. The particular entities mentioned were Matsushita, Exxon, Weight Watchers, Ciba Geigy, Pfizer, and Upjohn.

Matsushita, Exxon, and Weight Watchers

The support from Matsushita, Exxon, and Weight Watchers were not corporate contracts, but rather awards from three U.S.-based non-profit foundations that have policies, applied uniformly to all grantees prohibiting payment of indirect costs. The amounts of money involved were small enough that the University could afford cost sharing on the awards. Below is more information about these foundations and the specific projects they funded.

- Matsushita is an American-based educational foundation located in Delaware and funded by the Matsushita Electric Corporation of America. Recently renamed the

Panasonic Foundation, this sponsor's purpose is to provide assistance to US public education by funding projects that help to reform the public educational system (per the Foundation Directory, 1991 Edition, page 595.) The two Stanford projects funded by this foundation were for development of instructional curriculum materials, and are included in the list of US-based non-profit sponsors in ATTACHMENTS F AND G (pages 27 and 29 respectively.)

- The Exxon projects in question were funded by the Exxon Educational Foundation, a non-profit foundation in New Jersey founded in 1955 for the stated purpose of aiding U.S. education. The Stanford projects funded by this Foundation were for a series of policy studies on energy, national resources, and the environment (See page 40 of ATTACHMENT F and page 44 of ATTACHMENT G). All projects funded by the Exxon Corporation carried the University's full indirect cost rates.

- Weight Watchers Foundation, another non-profit Foundation separate from the Weight Watchers corporation, funded a $15,000 Medical School study of insulin regulation in the human body in a project entitled, "Does Insulin Regulation of Adiopocyte Metabolism Vary as a Function of Anatomical Location?" (see page 57 in ATTACHMENT G).

Ciba-Geigy, Pfizer and Upjohn Awards

With respect to Ciba-Geigy, Pfizer, and Upjohn pharmaceutical companies, with one exception the University recovered indirect costs at either the full sponsored research rates, or, for the clinical trials they funded, at the applicable clinical trial rate. That is, of the projects funded by these three companies in FY89 or FY90, several were categorized as regular sponsored research and included indirect cost recovery at rates at least as high as the government-negotiated rates for those years. The clinical trials funded by these companies were charged the clinical trial indirect cost rates, which are formally treated as partial indirect cost waivers from the regular off-campus organized research rates negotiated with the government. However, all clinical trials are subject to the same rate, including those funded by the federal government. (See more about Clinical Trials information in ATTACHMENT E.)

As noted above, one project funded by Pfizer did not include indirect cost recovery, in either FY89 or FY90, as it had been categorized by administrative error as a "Clinical Trial." That project appears on pages 57 of ATTACHMENT F and page 60 of ATTACHMENT G and is included since it was also reported in the University's Sponsored Project Expenditure Reports by error. In fact, those funds were donated by Pfizer many years ago (from 1965 to 1977) as an unrestricted donation for the faculty member's use.

VII. INDIRECT COST WAIVER REQUESTS NOT APPROVED BY STANFORD

Not included in this report are the requests for indirect cost waivers initiated by funding agencies and/or individual faculty members which were not approved by the University. We do not track such requests, as we have no reason to do so. Most such requests are not in writing, as they are most frequently denied at the time of a telephone inquiry. However, to provide an example of the University's refusal to grant waiver requests for large-scale foreign-sponsored projects, please refer to ATTACHMENT D. This is a 1990 memo written from Stanford's President Donald Kennedy to the Dean of the Medical School arguing against waiving indirect costs on several proposals submitted to the Japanese Science Foundation due to the size of the projects, their nature, and the fact that the funding agency was foreign. To quote from the President's memo:

> If we are to be competitive in the international R&D funding arena, we are going to have to help foreign agencies understand how research is funded in American universities and the critical importance, especially to private universities, of those agencies' funding the full costs of the research they sponsor. Given that we insist on full overhead from our own government, it would be ironic for Stanford to subsidize foreign-sponsored projects of this magnitude.

Waivers of indirect costs were subsequently not approved for any of those proposals submitted to the Japanese Science Foundation, even though this decision meant returning funds which had been sent by the sponsor due to their unwillingness to fund the indirect costs.

VIII. CONCLUSION

Indirect costs on sponsored projects are real costs which must be funded. In those cases where the indirect costs associated with a particular sponsored project are not funded by the external sponsor, Stanford must pay those costs from the University's General Funds, which are obtained primarily from student tuition, gifts to the University or endowment income. "Foregone" or "waived" indirect costs are never passed on to other sponsors, but are borne by the University.

As a result, Stanford can afford to grant indirect cost waivers only in small dollar amounts. Indirect costs not funded by external sponsors amounted to about $16 million in FY89 and FY90. This represents about 15% of total indirect cost expenditures.

The vast majority of foregone indirect costs (about 95%) can be attributed to projects funded by the federal government, state and local governments, and U.S.-based nonprofit sponsors. Between 60% and 65% of the total amount of foregone indirect costs is from U.S.-based nonprofit sponsors. About 25% of the indirect costs is waived for the federal government. State and local governments account for another 8%.

U.S.-based corporations and all foreign sponsors together account for only about 4% of the foregone indirect costs. The majority of this is due to Clinical Trials, in which all sponsors (including the federal government) are charged a standard Clinical Trial rate, which is below the government negotiated rates.

Many factors influence the University's decision to accept a project with less than full indirect cost funding. The most important factor is the size of the requested waiver. Waivers are much more likely to be granted on small projects than on large ones. Additional factors include the importance of the project to the faculty member and to the school, the needs of junior faculty, the nature and subject matter of the project (areas where funding opportunities are rare), the consistency with which the funding agency applies limitations on indirect costs, and the nature of the funding agency (nonprofit or government rather than corporate or foreign).

The Government-University partnership in the funding and conduct of America's basic research is critically important for the welfare of the nation. This partnership has been spectacularly successful in the advancement of science and technology, and is the envy of the rest of the world. Stanford stands ready to take whatever steps are necessary to support and improve this partnership.

Attached are summaries of both the numbers and the dollars of foregone indirect cost recoveries at Stanford for FY89 and FY90.

May 16, 1991

Stanford University Fiscal Year 1989

Indirect Costs foregone on all externally sponsored expenditures, as compared to Stanford's Indirect Cost Rates negotiated with the Federal Government

	Reason for waiver				
	A	B	C	A + B + C	% of IDC foregone
Sponsor Type	Sponsor Limit	Clinical Trials	Case-by-Case	IDC foregone	
Federal Gov't	$3,596,102	$413	$190,797	$3,787,312	23.81%
State & Local Gov't	$1,146,071	$0	$87,848	$1,233,919	7.76%
U.S. Nonprofit*	$10,185,876	$0	$7,651	$10,193,527	64.07%
U.S. Corporations	$0	$435,280	$187,438	$622,718	3.91%
Foreign	$0	$0	$71,980	$71,980	0.45%
Total	$14,928,049	$435,693	$545,714	$15,909,456	100.00%
% of Total	93.83%	2.74%	3.43%	100.00%	

NOTES:

A = Includes all waivers coded on the detailed list as AGENCY (agency limit), PROG (agency limit on this program), TR (training grant) and WL (included on waiver list).

B = Sponsored research projects known as Clinical Technology Assessment Agreements (CTAA on detailed list).

C = Includes all waivers granted after a case-by-case review by the Dean of Research Office, including 1) All requests involving corporate sponsors or foreign entities, whether profit or nonprofit; and 2) U.S., state and local government sponsors and U.S.-based nonprofit sponsors that are coded on the detailed list as CS (cost-sharing), HARD (hardship), SEED (seed grant), TRANS (transfer from another university) or SABTRV (travel grant or sabbatical leave).

* "U.S. Nonprofit" includes U.S.-based foundations, voluntary heath organizations and professional societies, other U.S. universities, nonprofit U.S. institutes and consortia, international aid organizations with U.S. participation (eg., World Bank, World Health Organization, NATO, etc.)

Stanford University Fiscal Year 1989
Number of externally sponsored projects on which indirect costs were foregone, as compared to Stanford's Indirect Cost Rates negotiated with the Federal Government

	Reason for waiver					
	A	B	C	A + B + C		
Sponsor Type	Sponsor Limit	Clinical Trials	Case-by-Case	IDC foregone	% of IDC foregone	Total Number of Projects
Federal Gov't	276	2	26	304	33.74%	1940
State & Local Gov't	32	0	8	40	4.44%	52
U.S. Nonprofit*	464	0	5	469	52.05%	661
U.S. Corporations	0	72	7	79	8.77%	322
Foreign	0	0	9	9	1.00%	25
Total	772	74	55	901	100.00%	3000
% of Total	85.68%	8.21%	6.10%	100.00%		

NOTES:

A = Includes all waivers coded on the detailed list as AGENCY (agency limit), PROG (agency limit on this program), TR (training grant) and WL (included on waiver list).

B = Sponsored research projects known as Clinical Technology Assessment Agreements (CTAA on detailed list).

C = Includes all waivers granted after a case-by-case review by the Dean of Research Office, including 1) All requests involving corporate sponsors or foreign entities, whether profit or nonprofit; and 2) U.S., state and local government sponsors and U.S.-based nonprofit sponsors that are coded on the detailed list as CS (cost-sharing), HARD (hardship), SEED (seed grant), TRANS (transfer from another university) or SABTRV (travel grant or sabbatical leave).

* "U.S. Nonprofit" includes U.S.-based foundations, voluntary heath organizations and professional societies, other U.S. universities, nonprofit U.S. institutes and consortia, international aid organizations with U.S. participation (eg., World Bank, World Health Organization, NATO, etc.)

Stanford University Fiscal Year 1990

Indirect Costs foregone on all externally sponsored expenditures, as compared to Stanford's Indirect Cost Rates negotiated with the Federal Government

	Reason for waiver				
	A	B	C	A + B + C	% of IDC
Sponsor Type	Sponsor Limit	Clinical Trials	Case-by-Case	IDC foregone	foregone
Federal Gov't	$4,263,135	$30	$234,919	$4,498,084	26.69%
State & Local Gov't	$1,426,620	$0	$29,527	$1,456,147	8.64%
U.S. Nonprofit*	$10,295,740	$0	$17,619	$10,313,359	61.20%
U.S. Corporations	$0	$380,122	$157,090	$537,212	3.19%
Foreign	$0	$0	$48,288	$48,288	0.29%
Total	$15,985,495	$380,152	$487,443	$16,853,090	100.00%
% of Total	94.85%	2.26%	2.89%	100.00%	

NOTES:

A = Includes all waivers coded on the detailed list as AGENCY (agency limit), PROG (agency limit on this program), TR (training grant) and WL (included on waiver list).

B = Sponsored research projects known as Clinical Technology Assessment Agreements (CTAA on detailed list).

C = Includes all waivers granted after a case-by-case review by the Dean of Research Office, including 1) All requests involving corporate sponsors or foreign entities, whether profit or nonprofit; and 2) U.S., state and local government sponsors and U.S.-based nonprofit sponsors that are coded on the detailed list as CS (cost-sharing), HARD (hardship), SEED (seed grant), TRANS (transfer from another university) or SABTRV (travel grant or sabbatical leave).

* "U.S. Nonprofit" includes U.S.-based foundations, voluntary heath organizations and professional societies, other U.S. universities, nonprofit U.S. institutes and consortia, international aid organizations with U.S. participation (eg., World Bank, World Health Organization, NATO, etc.)

Stanford University Fiscal Year 1990
Number of externally sponsored projects on which indirect costs were foregone, as compared to Stanford's Indirect Cost Rates negotiated with the Federal Government

	Reason for waiver					
	A	B	C	A + B + C		
Sponsor Type	Sponsor Limit	Clinical Trials	Case-by-Case	IDC foregone	% of IDC foregone	Total Number of Projects
Federal Gov't	312	2	32	346	36.85%	1969
State & Local Gov't	25	0	6	31	3.30%	48
U.S. Nonprofit*	471	0	4	475	50.59%	660
U.S. Corporations	0	72	9	81	8.63%	292
Foreign	0	0	6	6	0.64%	28
Total	808	74	57	939	100.00%	2997
% of Total	86.05%	7.88%	6.07%	100.00%		

NOTES:

A = Includes all waivers coded on the detailed list as AGENCY (agency limit), PROG (agency limit on this program), TR (training grant) and WL (included on waiver list).

B = Sponsored research projects known as Clinical Technology Assessment Agreements (CTAA on detailed list).

C = Includes all waivers granted *after* a case-by-case review by the Dean of Research Office, including 1) All requests involving corporate sponsors or foreign entities, whether profit or nonprofit; and 2) U.S., state and local government sponsors and U.S.-based nonprofit sponsors that are coded on the detailed list as CS (cost-sharing), HARD (hardship), SEED (seed grant), TRANS (transfer from another university) or SABTRV (travel grant or sabbatical leave).

* "U.S. Nonprofit" includes U.S.-based foundations, voluntary heath organizations and professional societies, other U.S. universities, nonprofit U.S. institutes and consortia, international aid organizations with U.S. participation (eg., World Bank, World Health Organization, NATO, etc.)

DCAA'S INVOLVEMENT IN MEMORANDA OF UNDERSTANDING, SPECIAL STUDIES AND NEGOTIATIONS AT STANFORD UNIVERSITY

BACKGROUND

The Defense Contract Audit Agency (DCAA) incorrectly testified at the March 13, 1991 hearings before the Oversight and Investigation Subcommittee of the House Energy and Commerce Committee that DCAA was not consulted on Memoranda of Understanding (MoUs) entered into between Stanford and the Office of Naval Research. Mr. Newton testified DCAA did not have an "opportunity to comment on the proposed allocation procedures beforehand" and was "never consulted on any MoU with regard to any money," (Testimony of 3/13/91 hearing, pp. 106, 107, tab #42). In fact, DCAA was consulted and involved in the negotiations of the MoUs, including the MoU on the library study, the utility study, equipment depreciation and other MoUs involving substantial sums of money.

In the late 1970s, ONR suggested, and the University agreed, that Stanford should set out its costing practices in writing. The government (both ONR and DCAA) would evaluate practices, changes would be negotiated, and the resulting agreements would be executed by the government and Stanford in the form of MoUs. The agreements were intended to be binding on both the government and the University. Most of the indirect costing policy MoUs were considered and negotiated by the government and Stanford between 1980 and 1983. Additional MoUs have been negotiated since then, with Rob Simpson or Paul Biddle negotiating on behalf of ONR, but most have been revisions to the previous 1980-83 agreements.

When OMB promulgated the 1979 revision to A-21, ONR, DCAA, and Stanford began meeting to develop a plan for reviewing policies at Stanford for possible changes required under A-21. ONR representative Jack Ducey insisted that DCAA be available to him and present at all discussions and negotiations in order to provide advice and counsel. During those negotiations, DCAA received a copy of every proposal and all correspondence with the government on every issue, including all issues resulting in an agreement (MoU). DCAA was not an "in and out" participant; DCAA was there for the full meeting at every meeting and negotiating session held with ONR. The government parties caucused occasionally during the negotiations and Stanford was made aware that ONR and DCAA conferred by phone or in person between meetings.

The following paragraphs and referenced documents demonstrate the scope of DCAA's participation in the review and negotiation of MoUs and Special Studies.

MOUS AND SPECIAL STUDIES

As indicated above, ONR representative Jack Ducey insisted that DCAA be present and participate as his accounting and audit advisor at each and every discussion and negotiation session, including the signing of the MoUs. DCAA received copies of Stanford's proposals for review prior to the formal meetings. The DCAA supervisory auditor who was assigned responsibility for Stanford or the Auditor-in-Charge also made observations during data collection phases of special studies.

LIBRARY STUDY

The history of the Library Study allocation methodology is contained in the University's November 19, 1990 response to DCAA's September 28, 1990 audit report on the Library Study. That response contains many documents evidencing DCAA's participation in the developing library allocation methodology, including the DCAA audit report in 1975 finding the 1974 Library Study results acceptable to the government.

Several MoUs relate to the 1981 Library Study, the report for which was transmitted in 1984. For this study, Stanford submitted a formal methodology proposal in advance. Stanford worked with both ONR and DCAA to address all of their questions and concerns through changes in methodology. Stanford also worked with ONR and DCAA to finalize the data collection forms (including instructions and definitions) and to select sample periods. DCAA made a number of observations during the collection of data for the study. The DCAA auditors involved in the 1981 study included D. Johnson, Kiger, Wing, Griffin and Otto.

The following ten documents clearly demonstrate DCAA's participation and concurrence in the 1981 Library Study methodology, sampling plan, data collection instrument design and data collection effort.

Tab #	Date	Document
1	6/30/75	DCAA review approving Stanford Library Cost Study
2	2/26/81	Riddle to Ducey, ONR, methodology proposal cc Griffin, DCAA
3	6/17/81	Sweet to Ducey, ONR, letter cc Griffin, DCAA
4	5/28/81	Martin to Sweet memo (refers to DCAA participation)
5	7/22/81	Martin to Distribution memo cc Griffin, DCAA
6	8/5/81	Martin to Sweet memo (refers to DCAA participation)
7	10/28/81	Martin to Sweet memo (refers to DCAA participation)
8	10/19/81	Sweet to Griffin, DCAA, and Simpson, ONR memo
9	2/23/84	Sweet to Simpson, ONR, letter cc Johnson, DCAA, and Kiger, DCAA
10	3/11/85	Sweet to Ducey, ONR, letter cc DCAA

UTILITY STUDY

Taylor Systems (an engineering firm) conducted the first Utility Study in 1981-82. Given the technical nature of the study, ONR assigned an engineer, Gordon Chapman, to work with Stanford and Taylor Systems engineers. Mr. Chapman spent time at Stanford before, during and after the study. DCAA did not have much involvement in this study due to the role of ONR's engineer. However, if DCAA had concerns with ONR's choice of engineer, DCAA was given ample opportunity to express it or arrange for its own engineer.

DCAA was well aware the study was going on. DCAA auditors made at least one walk-through and observation of data collection during the course of the study. DCAA received a full set of the study reports with the expectation it would audit; DCAA never chose to do so.

See the attached three documents evidencing DCAA's receipt of the full eight volumes comprising the report and two later correcting reports. Stanford's files contain other documents communicating with the ONR engineer.

Tab #	Date	Document
11	5/6/82	Sweet to Ducey, ONR, letter cc Kiger, DCAA, with attachments
12	10/25/82	Sweet to Ducey, ONR, letter cc DCAA
13	10/20/81	Sweet to Distribution memo (Negotiation memo for DCAA demonstrating DCAA viewing of the Utility Study collection efforts.)

MOU ON ENTERTAINMENT AND ALCOHOL

In 1976 DCAA and Stanford performed analyses of the unallowable entertainment and alcohol in the subsistence expense code for G&A and Departmental Administration. Negotiations with ONR resulted in an agreement to exclude 20% of the subsistence costs as unallowable instead of using a more cumbersome transaction by transaction approach. DCAA audited subsistence in the FY76 and FY77 Indirect Cost Studies and found the 20% decrement acceptable, as there were no audit findings in this area.

OTHER MOUS AND SPECIAL STUDIES

DCAA was actively involved in each and every one of the remaining special study and indirect costing and fringe benefit policy deliberations and negotiations during the five years (1980-1985) that most of them were negotiated. Attached are a number of documents demonstrating DCAA's awareness of and participation in the process. The agreements were entered into after participants from the three parties (ONR, Stanford and DCAA) discussed, evaluated and modified Stanford's proposals. When the agreements were negotiated DCAA did not express any concern with any agreement nor did it express any such concern in the audit of FY 1980 or the first audit of FY 1983.

DCAA's awareness and participation is chronicled in the following twenty eight documents. Stanford has located just a sample. There are likely other documents which have not been located, as well as the agreements contained in the MoU binder.

Tab #	Date	Document	Area Covered
14	3/21/80	Riddle to Ducey, ONR, letter	Definitions, MTDC, Sponsored Projects Administration (a new cost pool), Equipment Inventory System and Depreciation, Service Centers (refers to DCAA participation)
15	3/21/80	Riddle to Ducey, ONR, letter cc Schaff, DCAA, and Griffin, DCAA	Methodology for handling FY81 IDC proposal in transition to revised A-21
16	3/21/80	Riddle to Ducey, ONR, letter cc Schaff, DCAA, and Griffin, DCAA	Proposed delayed implementation for Equipment Inventory Effort Reporting and Tuition Remission
17	5/13/80	Mougin to Schaff, DCAA, memo (attachment to 5/21/80 Ducey letter)	Space Inventory (predominant use)
18	5/21/80	Sweet to Ducey, ONR, letter cc Schaff, DCAA	Space Inventory
19	8/15/80	Sweet to Ducey, ONR, letter cc Griffin, DCAA	Tuition Remission, Fringe Benefits
20	10/28/80	Sweet to Ducey, ONR, letter cc Schaff, DCAA	Amendment to definition of acquisition cost for equipment

21	10/28/80	Sweet to Ducey, ONR, letter cc Schaff, DCAA	List of MoUs agreed upon since 8/79: Tuition Remission, Definitions, Effort Reporting, Equipment Inventory and Depreciation, Delayed Implementation, Benefits matters, Computer pricing, On/off campus rate application, Rate application when conference component of project
22	1/21/81	Sweet to Distribution memo	DCAA Space Inventory Audit
23	2/2/81	Sweet to Geistlinger memo cc Griffin, DCAA	Government mandated P.L. 95-507 costs
24	2/9/81	Sweet to Ducey, ONR, letter cc Griffin, DCAA	Government mandated P.L. 95-507 costs
25	2/9/81	Sweet to Ducey, ONR, letter cc Griffin, DCAA	Effort Reporting
26	3/23/81-3/24/81	Agenda for Ducey, ONR, meeting	Tuition Remission, Effort Reporting, Equipment Inventory, Library Study (methodology presentation), Space Inventory, Depreciation of Buildings and Improvements (Also refers to DCAA participation)
27	4/3/81	Sweet to Distribution (including Griffin, DCAA) memo	Agreements reached at March negotiations: Tuition Remission, Effort Reporting, Equipment Inventory (use of scanners)

13	10/20/81	Sweet to Distribution memo	Agreements reached at October negotiations: Fringe Benefits, Effort Reporting, Depreciation of Buildings and Improvements. Other matters covered in discussions with ONR/DCAA: Utility Study in progress, Service Centers, Sponsored project close-out procedures, Upcoming TBSR program
28	12/7/81	Sweet to Distribution memo	Agreements reached at negotiations: Service Centers, Depreciation of Buildings and Improvements, Sponsored project close-out procedures
29	12/11/81	Steller, DCAA, to Ducey, ONR, report	DCAA review of Tuition Remission
30	1/28/82-1/29/82	Agenda for Ducey, ONR, meeting (DCAA attended meeting)	Effort Reporting, Tuition Remission, Utility Study, Status of G&A/SPA proposal, Building and Improvements. Listed items on which proposals were being developed: O&M (other than Utility), Student Services, Department Administration
31	5/28/82	Sweet to Ducey, ONR, letter cc Griffin, DCAA, and Kiger, DCAA	Agenda for June 2-3, 1982 meeting: Equipment Inventory, Buildings and Improvements, Student Services, O&M, exclude Rental/Lease from MTDC, move sabbatical leaves from DA to Fringe Rate beginning FY84, TBSR II, handling cross allocations
32	6/4/82	Sweet to Distribution memo	Reporting results of June 2-3 negotiation meeting with DCAA participating

33	12/13/82	Sweet to Distribution memo	DCAA 1982 Space Inventory audit
34	12/15/82	Riddle to Ducey, ONR, and Simpson, ONR, letter cc Griffin, DCAA, and Kiger, DCAA	Equipment Depreciation (simple system)
35	8/29/83	Sweet to Simpson, ONR, letter cc Kiger, DCAA	Fringe Benefits
36	10/5/83	Sweet to Simpson, ONR, letter cc Johnson, DCAA, and Kiger, DCAA	Fringe Benefits, Sabbatical leaves change FY84
37	8/3/84	Sweet to Distribution memo	Revisions to Buildings and Improvements agreements retroactive to 9/1/80 and reduction of FY81 and FY 82 carryforward, Department Administration allocation (DCAA to continue review of proposal)
38	2/28/85	Agenda for negotiations	Carryforward liquidation, Library Study, GA/SPA, Hospital Transactions Project, Benefits, Extension of Special Studies, DCAA Audit Backlog
10	3/11/85	Sweet to Ducey, ONR, letter cc DCAA	G&A/SPA, Library Study, Hospital Transactions Project
39	4/2/85	Sweet to Workman, DCAA, memo	Self insured Fringe Benefit programs

DCAA'S PARTICIPATION IN NEGOTIATIONS ON 1991 PROVISIONAL RATE

At the hearing before the Subcommittee on Oversight and Investigation, Mr. Newton of DCAA testified that DCAA was "not invited to the negotiation conference, at which time that 70 percent [negotiated] rate was arrived at" (Testimony of 3/13/91 hearing, p. 137, tab #42). Mr. Newton was wrong. Not only was DCAA invited, but it participated in the negotiations. The Office of the Chief of Naval Research (OCNR) negotiated a provisional rate of 72% in December 1990. DCAA was present at those meetings and the Interim Agreement specifically states that the agreement was reached "with the advice of the Defense Contract Audit Agency" (tab #40). The 72% rate was then reduced to 70% on February 6, 1991 and DCAA was again present for those negotiations (tab #41).

CONCLUSION

The documents attached to this memorandum prove conclusively that DCAA was actively involved in the planning, negotiation and execution of the MoUs. This involvement spanned many years, involved a large number of DCAA personnel and virtually all of Stanford's MoUs and cost studies. Moreover, these documents are merely examples of the scope of DCAA's participation.

These documents make inexplicable the sworn testimony of DCAA's representative before the subcommittee that DCAA did not participate in the MoU process.

STANFORD'S ACTIVE EFFORTS TO SEEK AUDITS FROM DCAA

Stanford has been greatly concerned through the years about DCAA's failure to conduct timely audits at Stanford. When Stanford requested audits, DCAA's standard response was that its priorities were at commercial defense contractors where the risk was greater and that authorized staffing levels were insufficient to get the job done.

DCAA did participate at ONR's request, by providing accounting and auditing advice, in the negotiation of the MoUs and Special Studies. DCAA's involvement in audit activity in the early to mid 1980s was considerable. However, most audits were started but never finished. Stanford and DCAA invested considerable resources in these audits with no results, as no reports were completed or issued. We understand DCAA has removed these uncompleted audits from its log.

Stanford took special efforts to assist DCAA in catching up during this time. In 1984, DCAA had just completed the FY80 Indirect Cost Study. Concerned over DCAA's growing backlog, Stanford proposed that the University forego $400,000 per year in carryforward for Fiscal Years 1981, 1982 and 1983 and that DCAA concentrate audit efforts on the FY83 Indirect Cost Study. If negotiated audit findings exceeded the $400,000, DCAA would perform audit work in FY81 and FY82; if findings for FY83 did not exceed $400,000, no further audit work would be done for FY81 and FY82. DCAA concurred with this approach, and an agreement was reached on May 3, 1985. See tab #5 and tab #6.

The following lists correspondence and important meetings and telephone calls regarding DCAA's unwillingness or inability to audit at Stanford:

	Date	Document	Area Covered
1	12/10/79	Sweet to Distribution memo	Internal transmittal of audit list given to Stanford by DCAA. DCAA audit support for A-21 changes is a major item.
2	1/9/81	Sweet to Griffin, DCAA, letter	Lists audits in progress and asks for status report

3	9/23/83	Meeting with DCAA. Stanford participants: Creighton, Controller Riddle, Assoc. Controller Sweet, Asst. Controller DCAA participants: Bokelman, RAM Carter, Branch Manager Johnson, Supervisory Auditor Kiger, AIC	Stanford: want current, timely, in depth audits so can act timely if problems are found. Asked what DCAA could do to bring auditing up to date. Need good communication: entrance/exit conferences and communicate during audit. Need more audits and adequate staffing
4	10/10/83	Sweet to Johnson, DCAA, letter cc Kiger, DCAA	Expressed concern over DCAA's lack of audit of space inventory, noted space inventory was ready for audit
5	2/8/85	Carter, DCAA, for Bokelman, DCAA to Ducey, ONR	States that "the Governments' interest would be adequately protected" by Stanford's proposed method for closing Fiscal Years 1981, 1982 and 1983
6	5/3/85	Simpson, ONR, to Riddle cc DCAA/Sunnyvale	Confirms the March 1985 agreement for closing Fiscal Years 1981, 1982 and 1983
7	2/23/87	Sweet to Lee, DCAA, letter cc Riden, DCAA	Confirms Lee's notice to Stanford of change in DCAA audit focus. Also confirms DCAA's dates for completion of audit reports. Stanford concerned with backlog.
8	3/31/87	DCAA/Stanford Meeting (agenda and notes) Stanford participants: Creighton, Sweet DCAA: Riden, Lee	Stanford concerned over DCAA audit backlog and wants to be up to date.
9	4/9/87	Sweet to Lee, DCAA, letter	Expressed Stanford's concern that DCAA cost audits be done on a sound basis from the start

10	7/14/87	Monthly meeting (agenda)	DCAA staffing. Reference to MoU review. Stanford offer of training for DCAA staff.
11	9/4/87	Sweet to Riden, DCAA, letter (agenda attached for 9/15/87 meeting)	Concern about cancelling monthly meetings. Hopeful that changes in DCAA staff will make it possible for DCAA to catch up on the substantial backlog of Stanford audits.
12	9/28/87	Sweet to Riden, DCAA, letter cc Lee, DCAA	Stanford's concerns: DCAA's lack of follow through with government agencies on DCAA's "new" procedures, lack of DCAA audits at Stanford, uncompleted audits, lack of DCAA staff assigned to Stanford, lack of signoff on Student Services study in spite of repeated ONR requests for audit. Stanford stated "good solid audit coverage by DCAA at Stanford is important to us."
13	11/12/87	Monthly meeting (agenda)	Old audits list provided. Reviewed Stanford workload so DCAA could best plan timing of audits.
14	11/18/87	Chan, DCAA, to Bucy telecon	Chan says the old audits have been removed from DCAA tracking system. Only FY84 and FY85 direct cost and ITS FY80-85 are still on system. Riden says "We will do as little as we can at Stanford." FY87 Space Inventory will not be audited. DCAA still has no audit staff on campus.
	10/19/88	AGA Meeting (Reed speaker; Biddle, now ONR, invited Sweet)	After speech, Sweet expressed to Reed and Topf concern over DCAA backlog at Stanford.

At this point (late 1988) Stanford was so concerned about the lack of any audit oversight from DCAA that Stanford's Chief Financial Officer Bill Massy was going to meet with Mr. Topf of DCAA. However, in January 1989, DCAA finally brought in five auditors from Utah to audit FY84-FY86 direct and indirect costs (using the FY84 and FY85 direct cost audit done earlier by Lee and Branham of DCAA). They finished in June 1989, but unfortunately, this latest attempt to conduct an audit failed again.

Instead, Mr. Riden's DCAA office would not permit an exit conference. In August 1989 Jo Callihan from Mr. Riden's office came in to do "a couple of weeks of wrap-up work." That lasted until August 1990. We now understand from Mr. Lloyd that DCAA decided to ignore the thousands of hours of work done by DCAA auditors from Utah on FY84-FY86. Instead, all work was duplicated by local DCAA auditors. The DCAA report on FY84-FY86 indirect costs was issued in August 1990, the first completed annual audit reports from DCAA since the FY83 audit was completed in 1987.

DCAA has yet to report on the direct cost portion of the audit, in which we understand there are no findings.

CONCLUSION

Far from seeking to avoid DCAA review, Stanford actively sought it out. Stanford understood that under years of neglect by the responsible auditors, numerous complex issues and misunderstandings could accumulate. Unfortunately, Stanford was unable to persuade DCAA to complete an audit for several years.

Stanford University
OFFICE OF THE CONTROLLER

April 19, 1991

Michael Kuc
Special University Team
OCNR
800 N. Quincy
Ballston Tower #1, Rm 907
Arlington, VA 22217-5000

Subject: Costs Withdrawn from IDC Claims

Dear Mike,

You raised a question last week about what costs have been officially removed by Stanford from the Indirect Cost Study carryforwards. Attached is a schedule summarizing these adjustments by year. The impact on the government carryforward for each year has been approximated by multiplying the cost pool adjustment by the approximate percent allocated to Organized Research and by the approximate percent which Government Research is of Organized Research.

Also attached are copies of the letters in which said adjustments were communicated to the government. Our normal process would be to notify the cognizant chief negotiator of a reduction or adjustment in our claim. That would have been Paul Biddle, then John Ford, and then you. In reviewing the correspondence, we find two letters dealing with the Shopping Center error in FY86 & FY87 and the Centennial costs for FY87 & FY88 which were addressed to Joe Riden of DCAA (3/4/91) and Doreen Eng of the GAO (3/7/91), respectively, rather than to you. (You received a copy of each, however.) Please consider these costs formally withdrawn.

On March 15, we also notified you of our intent to remove certain other costs associated with the three University-owned houses, as well as some club memberships. Preparation of the response to the DCAA audit report and support for negotiations last week slowed down this analysis, but it should be completed and snet to you soon. Any other items, such as the Chancellor's House maintenance, with which we concurred in connection with DCAA's audit report will also be formally withdrawn.

DCAA has evidently raised the question of whether carryforwards and, hence, these adjustments to carryforwards, are recorded in the accounting system. The indirect cost allocation process is in workpapers supporting the formal submission. The indirect cost carryforward is not recorded in the accounting system. These formal revision letters constitute the necessary adjustment to the University carryforward claim.

Should you have any further questions, please call me at (415) 725-1759.

Sincerely yours,

Janet Sweet

Janet Sweet
Assistant Controller

Adjustments to Indirect Costs

(ESTIMATED EFFECT ON GOVERNMENT ORGANIZED RESEACH CARRYFORWARDS)

YEAR (1)	ALLOWABLE COST GROUP VOLUNTARILY REMOVED				CORRECTION OF ERRORS					
	UNIVERSITY HOUSES 1/23/91 (2)	ADDITIONAL ADJ. LAKEHOUSE 3/11/91	RECEPTION 3/11/91 (3)	SUB-TOTAL	PHYSICAL EDUCATION 11/29/90 (4)	SHOPPING CENTER 3/4/91	PUBLIC AFFAIRS CENTENNIAL 3/7/91	DEVELOPMENT CENTENNIAL 3/7/91	SUB-TOTAL	TOTAL
FY81	29,090			29,090	2,169				2,169	31,259
FY82	48,837			48,837	5,235				5,235	54,072
FY83	50,761			50,761	11,368				11,368	62,129
FY84	64,703			64,703	11,162				11,162	75,865
FY85	63,227			63,227	12,308				12,308	75,535
FY86	82,446			82,446	12,692	74,619			87,311	169,757
FY87	88,403	5,288		93,691	39,680	88,161	(105,600)		22,241	115,932
FY88	92,823	3,992	3,668	100,483	98,821	0	0	149,814	229,435	329,918
	520,290	9,280	3,668	533,236	184,285	162,780	(105,600)	149,814	381,279	924,517

(1) DATES REPRESENT WHEN THE COSTS WERE OFFICIALLY WITHDRAWN

(2) GENERAL & ADMIN COSTS REMOVED FOR HOOVER HOUSE, HONEYCOMB HOUSE, AND LAKE HOUSE.

(3) TRUSTEE RECEPTION FOR KENNEDYS

(4) DEPARTMENT OF PHYSICAL EDUCATION NON-AUXILIARY EQUIPMENT COSTS (INCLUDES VICTORIA)

(5) 3/13/91 THE GOVERNMENT WAS NOTIFIED THAT STANFORD UNIVERSITY WOULD REMOVE SOCIAL CLUB DUES, SPECIAL MAINTENANCE AND LANDSCAPING COSTS, DEPRECIATION FOR FURNITURE AND EQUIPMENT IN THE THREE HOUSES. STANFORD ALSO INTENDS TO REMOVE THE O&M ACCOUNT FOR THE CHANCELLOR'S HOUSE.

DATA FILE:COSTSEN1

UNIVERSITY CONFIDENTIAL

NOTICE: This material is exempt from FOIA disclosure under 5 U.S.C. Section 552

Stanford University
OFFICE OF THE CONTROLLER

November 29, 1990

Hand-delivered

Mr. Paul L. L. Biddle
Resident Representative
Office of Naval Research
202 McCullough Bldg.
Stanford, CA 94305

Subject: Revised IDC carryforward due to error in equipment depreciation

Dear Paul:

The purpose of this letter is to submit formal revisions to the Indirect Cost Studies from FY81-FY88 for an error detected in the calculation of the equipment depreciation cost pool. As a result of the GAO requesting information on the accounting transactions associated with the boat named Victoria, we discovered an error in equipment depreciation in our indirect cost submissions.

Our expectation is that equipment associated with Auxiliary Activities, including the Athletic Department programs such as the sailing program, is not recorded in an account which will be used for equipment depreciation calculations in the Indirect Cost Studies. Therefore, no square footage was included in the equipment depreciation allocation base for Auxiliary Activities.

Unfortunately, we did not realize that some boat donations and some equipment purchases for the Athletic Department were booked into accounts which are included in the equipment depreciation cost pool. In the Indirect Cost Studies, equipment depreciation is allocated among functions, including Organized Research, based on square footage of space used by those functions. Given that no Athletics Department square footage was in the allocation base, there was an inconsistency between the cost pool and allocation base.

To rectify this problem, we hereby submit a revision to our IDC submissions for the FY 81-FY 88 as calculated on the attached schedule. Downward adjustments to the carryforwards in each year are summarized below:

837 Encina Commons
Stanford, California 94305-6225
PHONE (415) 723-1780
FAX [illegible]

FY 81	$ 2,169
FY 82	$ 5,235
FY 83	$11,368
FY 84	$11,162
FY 85	$12,358
FY 86	$12,692
FY 87	$39,680
FY 88	$89,621

Copies of this revision to the carryforward have been provided to DCAA and to the GAO. Detailed schedules supporting these adjustments will be provided shortly to DCAA and the GAO.

With regard to the FY91 and FY92 proposed indirect cost rates, the dollar impact of this error is so small (.08 rate points in FY88) that it does not impact these proposed rates as the proposed rates are rounded off to the nearest whole percentage point. Of course, when we do the calculations of actual rates for these years, we will eliminate these items.

We regret that this mistake occurred and will check to make sure that there is no similar problem with the other Auxiliary Activities. If there is, we will calculate the impact and submit a further carryforward revision. Of course, we will ensure that this mistake will not be made in future years.

If you have any questions, please call me.

Sincerely,

Janet Sweet

Janet Sweet

Enc.

cc: Doreen Eng, GAO
Larry Horton
Fran Reed
Frank Riddle
Joe Ridea, DCAA
Rob Simpson, ONR
Debra Zumwalt

Summary of Adjustment to Government Organized Research (OR)
for Athletic Department Equipment
For years FY81 - FY88

Year	Athl.Dept Equip. in depreciable base	Depr Factor (Note 1)	Depr for Each Yr's New Equip Additions	Adjustment in Equip for Year (Note 2)	Percent Equip. Depr Allocated to OR	Total Effect on OR IDC Rate points	Total Effect on OR Rate	Effect on Govt. Org. Research Carryforward
FY67	$1,760	6.67%	$117					
FY68	4,758	6.67%	317					
FY69	1,516	6.67%	101					
FY70	1,716	6.67%	116					
FY71	1,232	6.67%	82					
FY72	1,514	6.67%	101					
FY73	1,345	6.67%	90					
FY74	1,744	6.67%	116					
FY75	3,369	6.67%	225					
FY76	12,511	6.67%	834					
FY77	17,143	6.67%	1,143					
FY78	7,195	6.67%	480					
FY79	6,191	6.67%	413					
FY80	6,642	6.67%	443					
FY81	2,435	6.67%	162	$4,738	50.50%	$2,393	0.00	$2,169
FY82	107,500	6.67%	7,167	11,788	50.31%	5,930	0.01	5,235
FY83	150,300	10.00%	15,030	26,501	49.81%	13,199	0.02	11,368
FY84	1,200	10.00%	120	26,520	49.52%	13,133	0.01	11,162
FY85	27,581	10.00%	2,758	29,163	49.16%	14,336	0.01	12,358
FY86	6,745	10.00%	675	29,556	50.18%	14,831	0.01	12,692
FY87	639,350	10.00%	63,935	93,390	50.45%	47,113	0.04	39,680
FY88	1,218,600	10.00%	121,860	215,160	49.91%	107,392	0.08	89,621

Cumulative Effect on Carryforward $184,286

Note 1: 6.67 Use allowance used through FY82; 10 year straight line used beginning FY83.

Note 2: Equipment depreciation for a given year is the sum of depreciation for new equipment additions for the past 15 years.

Stanford University

OFFICE OF THE CONTROLLER

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January 23, 1991

John W. Ford, Jr.
Special University Team
OCNR
800 N. Quincy
Boston Tower #1, Room 907
Arlington, VA 22217-5000
Code OOUT

Subject: Announcement of University Initiative

Dear John:

Attached is a statement from Don Kennedy which has been hand delivered this morning to Congressman Dingell. Also attached is a related press release which will be released by the University at 8:00 A.M. PST today and a sample of the letter confirming membership on the Advisory Panel.

One of the three aspects of the initiative is Stanford's voluntary withdrawal of certain costs. To understand how the amount of voluntary withdrawal for house accounts was determined and what is included in it by year, we have prepared the attached schedule. The General & Administrative costs, which have not already been excluded, for the President's house operations (Hoover House), Provost's house operations (Hanna House), and the Vice President for Public Affair's house operations (Lake House) are being withdrawn for the open years (FY81-FY88) for which an Indirect Cost Study has been submitted to the Government. The accounts, years, amounts and their approximate impact on the allocation to government research are detailed on the schedule.

As you are aware, the carryforwards from FY81-FY85 go into the FY88 actuals. Therefore, the impact of this voluntary withdrawal on the FY91 rate by virtue of the FY88 carryforward is around $350K. As we discussed last week, Stanford anticipated this adjustment as a part of the reduction when we proposed the 76% rate which is over a point less than the calculated rate. The FY86 & FY87 carryforward adjustments impact the FY92 & FY93 years, respectively, as they will be included in the FY89 and FY90 carryforwards, respectively.

As indicated in President Kennedy's statement, we wish to negotiate with you the treatment of these costs for years subsequent to FY88 and propose this issue be added to our MoU review task list. We believe this category of cost is allowable, reasonable, and allocable, but due to the recent acute public attention want to make sure we have agreement with the government on how to handle them.

If you have further questions about this before your return to campus, please feel free to contact either Janet Sweet or me.

Sincerely,

Franklin G. Riddle

Franklin G. Riddle
Controller

FGR/hw

Attachments

UNIVER Y
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Voluntary Reduction of Costs Claimed for Sensitive Accounts

	Hoover House				Hanna House				Lake House				
	7K82002				7K82003				BJAA004				TOTAL
	Total Expenditures	Cost Pool Amount	Account Grouping	*Allocated to Government	Total Expenditures	Cost Pool Amount	Account Grouping	*Allocated to Government	Total Expenditures	Cost Pool Amount	Account Grouping	*Allocated to Government	Allocated to Government
FY81	$129,742	$121,180	GA	$27,708	$4,666	$4,467	PRO	$1,382	$0				$29,090
FY82	$227,088	$197,143	GA	$45,077	$12,460	$12,154	PRO	$3,760	$0				$48,837
FY83	$226,930	$207,596	GA	$47,466	$10,816	$10,667	PRO	$3,296	$0				$50,761
FY84	$271,089	$251,107	GA	$57,416	$26,003	$25,352	PRO	$7,287	$0				$64,703
FY85	$248,999	$231,034	GA	$52,826	$33,283	$31,125	PRO	$9,630	$3,403	$3,373	GA	$771	$63,227
FY86	$286,445	$263,385	GA	$60,223	$75,277	$68,015	PRO	$21,044	$5,199	$5,158	GA	$1,179	$82,446
FY87	$313,872	$287,364	GA	$65,706	$79,334	$75,171	PRO	$22,639	$253	$253	GA	$58	$88,403
FY88	$372,277	$317,434	GA	$72,586	$72,084	$65,398	PRO	$20,234	$12	$12	GA	$3	$92,823
Total	$2,073,242	$1,876,261		$429,007	$312,723	$288,529		$89,271	$8,867	$8,796		$2,011	$520,289

*Note - The dollars allocated to Government research are computed by first multiplying the amount included in the cost pool by the percentage that pool is allocated to Organized Research. For the General & Administrative (G&A) cost pool's General Administration (GA) cost grouping, the percentage allocated to Organized Research is approximately 26.9%, based on FY85 actuals; for the Provost (PRO) cost grouping in the G&A cost pool, the percentage allocated to Organized Research is approximately 36.4%, based on FY85 actuals. After the dollars allocated to Organized Research have been computed, they are then multiplied by the percentage which Government Research is of total Organized Research, which is approximately 85%.

Stanford University
OFFICE OF THE CONTROLLER

March 4, 1991

Mike Kuc
Special University Team
OCNR
800 N. Quincy
Boston Tower #1, Rm 907
Arlington, VA 22217-5000

Subject: Additional costs voluntarily removed

Dear Mike,

As you have heard, the University is adding to its list of voluntary deletions communicated in the attached January 23, 1991 letter to John Ford. A reception was held December 1987 by the Trustees, after the marriage and wedding reception (paid by President Kennedy), for the President and Mrs. Kennedy to introduce her to the University community in her new role as the President's wife and University hostess. This has been misreported in the press as the wedding reception.

We have yet to go through the transactions in detail to determine how much has already been adjusted in the FY88 Indirect Cost Study, but we will be doing that soon and getting it to DCAA.

In reviewing the schedule attached to the letter of 1/23/91, we discovered Lake House charges in other accounts. These dollars are not large, but we will update the schedule as soon as we have analyzed the situation.

Both of these adjustments to the original voluntary deletion only impact Gov't Research around 23%, so the impacts originally communicated will not be changed much.

If you have questions, please feel free to call me at (415) 725-1759.

Sincerely Yours,

Janet Sweet

Janet Sweet
Assistant Controller

JS/ks

Attachment

FILE

Stanford University
OFFICE OF THE CONTROLLER

March 4, 1991

Joseph P. Riden
Branch Manager
Redwood Branch Office
Defense Contract Audit Agency
P.O. Box 61029
Sunnyvale, CA 94088

Subject: Reception and Shopping Center Costs (T-97)

Dear Joe,

Your letter dated February 22, 1991 arrived on February 28, 1991, the date by which you requested a response. Faxing these to us instead of mailing them will expedite response.

Attached please find your copy of a letter to Mike Kuc regarding the reception. This was not a wedding reception. We have decided to remove it along with the Hoover House functions and expenses for the same reasons that we removed the other House operating expenses.

As to the Shopping Center, in reviewing this for the GAO, we discovered we handled account 7SAB003 incorrectly in FY86 ($324,430) and FY87 ($383,307) as allowable; about 23% of these costs were allocated to government organized research. We consider these costs to be unallowable under OMB A-21 section J.17.c., as the Shopping Center is an investment of the Stanford Endowment and is solely to enhance income, rather under than C.4.a. In FY88, we caught the mistake and excluded it as unallowable.

If you have further questions, let either Fran Reed or me know. The reception and additional Lake House adjustment specifics will be coming soon.

Sincerely,

Janet (A)

Janet Sweet
Assistant Controller

JDS:ks

cc: L. Horton
D. Zumwalt
W. Byer
F. Reed
F. Riddle
W. Massy
M. Kuc, OCNR
D. Eng, GAO

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PHONE (415) 725-1759
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Jc.11c1

Stanford University

OFFICE OF THE CONTROLLER

March 7, 1991

Doreen Eng
General Accounting Office
1275 Market St., Ste 900
San Francisco, CA 94103

Subject: Centennial Costs

Dear Doreen,

It is with great apologies that I finally respond to your oral request of 11/30/90 regarding how the Centennial costs were treated and whether they were for fund raising. As I orally responded to you, the 100th Anniversary of the founding of a non-profit organization like the University provides a time for celebration and reflection on the past and future as well as an opportunity for fund raising. Centennial Activities are being coordinated by two offices at Stanford University:

The Office of Development - for fund raising purposes, and;
The Public Affairs Office - for celebration and professional seminars.

In reviewing how we handled the Centennial costs, it is complicated in that new information requires changes going both ways. I have identified the accounts in which Centennial costs are collected, how they were handled and how they should have been handled.

The Office of Development

The Office of Development costs are contained in account 8TAC006 and 8TX. The 8TX accounts were opened in FY89, are all for fund raising and will be treated as unallowable. The 8TAC006 account was opened in FY87. No costs were incurred in this account in FY87 and therefore it did not have to be handled in the cost study for that year.

Based on the information provided to us at the time we were computing the actual costs for FY88, all of the 8TA accounts (including 8TAC006) were considered 55% allowable. Upon re-evaluation, OOD determined that the expenses in 8TAC006 should be

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treated as fund raising costs and excluded; and further that only 40% of the remaining 8TA's (excluding 8TAC006) should be allowable. With this adjustment, the allowable FY88 costs for the 8TA series of accounts should be $420,311 rather than the $1,074,523 as shown on the FY88 cost study. The calculations for this adjustment are shown on the attachment.

Office of Public Affairs

Costs of the Centennial are in 8UAA008 in the Office of Public Affairs. Costs are incurred in this account to commemorate and celebrate Stanford's history and focus on its future. This includes professional seminars where faculty members share research findings with others and discuss new research opportunities. In FY87, the first year in which costs were incurred, this account was excluded from the G & A pool; we see no explanation for the adjustment. In FY88, the costs were left in. In reviewing the purpose for the costs, we conclude they are allowable and allocable. Therefore, an adjustment to reinstate the 8UAA008 costs for FY87 in the amount of $461,129 should be made.

Call me if you have further questions.

Sincerely yours,

Janet

Janet Sweat
Assistant Controller

JDS:km

cc: L. Horton
D. Zumwalt
G. Riden, DCAA
F. Reed

Office of Development Adjustment for STAC006 Centennial Costs - FY88

	Per Cost Claim	Corrected Adjustment for STAC006
Total STA costs	$1,982,726	$1,982,726
Less STAC006		(924,459)
Adjusted STA	1,982,726	1,058,267
Less Equipment	(683)	(539)
Less Subsistence	(28,365)	(6,951)
Net STA costs	1,953,678	1,050,777
Allowable percentage	55.00%	40.00%
Allowable STA costs	$1,074,523	$420,311

Stanford University
OFFICE OF THE CONTROLLER

March 11, 1991

Mike Kuc
Special University Team
OCNR
900 N. Quincy,
Boston Tower #1, Rm 907
Arlington, VA 22217-5000

Subject: Lake House and Trustee Reception Voluntary Removals

Dear Mike,

As indicated to you in my letter of March 4, 1991, we are withdrawing from SU's indirect cost submissions for FY87 and FY88 the following amounts associated with Lake House Operations (in addition to those mentioned in the Jan. 23 letter) as well as the Trustee reception for President and Mrs. Don Kennedy. Both of these amounts are in the General Administration(GA) cost group in the General and Administratve(G&A) cost pool.

Trustee Reception

This reception occurred in FY88 and, therefore, affects FY88 only. The adjustment to the GA cost group is $16,019. (The total cost of the reception was $18,206 less $2,187 which had already been reduced by the 20% subsistence adjustment for unallowable entertainment and alcohol). The impact to the Government for this adjustment is approximately 23% of this amount or $3,684.

Lake House Expenses

It was discovered after submission of the January. 23, 1991 voluntary reduction letter that not all of the expenses for FY87 and FY88 were charged to the Lake House account, 8UAA004. Instead, they were charged to other Public Affairs accounts. We have researched these items and have identified the following additional expenses pertaining to the Lake House which will be removed from the GA cost group for FY87 and FY88. For FY87, the costs to be removed from the GA cost group are $ 22,990 ($23,603 less $613 already deducted as unallowable subsistence and entertainment). For FY88, the amount to be removed is $17,356 ($18,161 total costs less $805 already deducted as unallowable subsistence and entertainment) The impact to the Government is approximately 23% of the $22,990 or $5,288 for FY87 and 23% of $17,356 or $3,992 for FY88.

The workpapers for these adjustments are being made available to DCAA. We are still researching to see if any other Lake House operations were also charged to other accounts in earlier years. We will inform you of any adjustments resulting from this effort.

Please feel free to call me if you have any questions.

Sincerely yours,

Janet (FE)
Janet Sweet
Assistant Controller

FILE

Stanford University
OFFICE OF THE CONTROLLER

March 15, 1991

Mike Kuc
Special University Team
OCNR
800 N. Quincy, Boston Tower #1, Rm 907
Arlington, VA 22217-5000

Subject: Additional Expenses Withdrawn FY81-88

Dear Mike,

As you know, Stanford has withdrawn the costs related to the operations of the Hoover House, Hanna House, and Lake House. We intend to withdraw also special landscaping accounts, furnishings and equipment depreciation for those three houses and the Hoover House apartment refurbishing.

Also, Stanford had a policy reimbursing approved Faculty and Senior Staff for some club memberships, where Stanford felt that the membership would benefit the individual's job performance at Stanford University. After FY88, Stanford changed its policy of reimbursement for these club memberships. While the purpose of the memberships was definitely Stanford business in nature, these may be considered sensitive items and we intend to remove them also for FY81-FY88.

At this time, we do not know the exact amount for both of these withdrawals. We will advise you next week of the amounts. Please feel free to call me if you have any questions.

Sincerely,

Janet Sweet

Janet Sweet
Assistant Controller

JDS:fr:ks
cc: J. Erlan, GAO
J. Riden, DCAA
F. Reed
F. Riddle
D. Zumwalt
R. Byer
L. Horton
W. Massy

127 Encina Commons
Stanford, CA 94305-6035
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STANFORD UNIVERSITY

OFFICE OF THE
VICE PRESIDENT AND GENERAL COUNSEL
TELEPHONE (415) 723-9611

P.O. BOX N
STANFORD, CALIFORNIA 94309
Facsimile (415) 723-4323

May 9, 1991

HAND DELIVER

Mr. Michael Kuc
OCNR
800 N. Quincy
Ballston Tower #1, Room 907
Arlington, VA 22217

Dear Mr. Kuc:

I enclose two Stanford checks totaling $1,030,117.

As you know, Stanford had already voluntarily withdrawn costs in the amount of $924,517 by the normal and accepted method of adjusting the carryforward (as described in Janet Sweet's April 19, 1991 letter to you). This included a credit for $105,600. You have requested that we pay the full amount of adjustments in the government's favor -- $1,030,117 -- without an offset in that payment for Stanford's credit (that credit can be carried forward). As a special accommodation to the government, we have agreed on a one-time basis to reverse the adjustment to the carryforward and pay the full amount of the adjustments by check to the United States Treasury.

We received your letter of May 7, 1991 in response to our concern that other government agencies which contracted with Stanford might seek to recover the same funds if we paid the money to the Treasury (which does not benefit the contracting agencies) instead of adjusting the carryforward (which does benefit the agencies). You instructed us to write the check to the U.S. Treasury and assured us that this was coordinated with the Office of Management and Budget so that Stanford will not be subject to claims that the payment to the U.S. Treasury was the wrong procedure. We are relying upon your instructions and advice in this regard in making this payment.

Your letter also mentions that the Government does not waive any entitlement it may have under DFAR Subpart 231.7001 to interest and/or penalties. As a matter of legal interpretation, we do not believe that the DFAR section is applicable to the voluntary withdrawals; we acknowledge that you may have a contrary view. In addition, under established procedure with ONR and the way these very withdrawals were initially made, the carryforward has been adjusted and there has been no interest paid to the Government (or received by Stanford).

Stanford is tendering these checks on the express understanding that the Government recognizes that we are not waiving any legal rights or creating any new legal obligations by doing so instead of adjusting the carryforward. Likewise, Stanford agrees that the Government is not waiving any of its legal rights.

In recognizing that Stanford has not waived any rights it may have, the Government does not concede that it would have been proper for these refunds to have been included in the carryforward adjustment or that the Government is not entitled to interest on the amount refunded. The Government's position is that expressly unallowable amounts could not be included in a carryforward; the Government acknowledges that Stanford has a contrary view.

In accordance with your request, I have canceled the endorsement on the check for $924,517 by marking through and initialing it. I am duly authorized to take this action on behalf of Stanford.

Very truly yours,

Debra L. Zumwalt

Debra L. Zumwalt
Senior University Counsel

Enclosures

cc: DCAA HQ (Fred J. Newton)
DCAA Redwood (Joseph Riden)
Stanford (William Massy)

DECLARATION OF NORLING

I, Ralph L. Norling, declare:

1. I am an Accredited Senior Appraiser of the American Society of Appraisers. My professional category is Personal Property Appraiser, certified in Residential Contents-General and in Antiques and Decorative Art. I make these statements to the best of my knowledge and belief.

2. On January 3, 1985, I made an appraisal of certain items from the Estate of Alice Meyer Buck. A true and correct copy of the appraisal is attached hereto as Exhibit A. The person who asked me to make the appraisal was Margaret Dilg, an interior decorator who was working at Hoover House at Stanford. I did not deal with anyone else at Stanford concerning this appraisal.

3. I conducted the appraisal as I normally do appraisals of donated items. I valued the items at "actual cash value" which results in a value less than "replacement value."

4. I understand some questions have been raised about my method of item-by-item appraisal. No one instructed me to do it this way; this is the way I always do such an appraisal and it is an accepted practice. For instance, it is my custom to separately appraise pieces of silver flatware by function, as I did in the attached appraisal, particularly when the silver is not a full set.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct. Executed this 15th day of March, 1991, at San Francisco, California.

Ralph L. Norling

Ralph L. Norling, A.S.A.

DECLARATION OF CAROLYN MORRIS

I, Carolyn Morris, declare:

1. I was employed by the Stanford University Controller's Office for 21 years. During that time, one of my responsibilities was to see that the account number assigned to transactions entered into the Stanford University accounting system was correct.

2. On or about October 24, 1985, I processed the transfer of expense form for the purchase of silverware and other items by the Hoover House Operations Account (President's Office). The aggregate fair market value of the silverware and other items, as established by an independent appraisal supplied to the University, was $10,505.00.

3. On that transfer of expense form, I entered account numbers (7RBZ002 94610-94681) indicating that the silver was to be handled as an expendable item, rather than a capital item.

4. Under the rules of the Stanford University Financial Information Network, an item should be treated as an expendable item rather than a capital item unless the item has both a value greater than $500 and a useful life of more than two years.

5. The classification of the silverware as expendable items represented my independent judgment as to the proper classification of the silverware. I have no recollection of asking for or receiving instructions on the treatment of the

silverware. As a general matter, individuals in my office worked fairly independently in processing such transactions.

6. It was my opinion that this silverware should be expensed because, like the independent appraiser, I valued the silverware on the basis of individual pieces, not the set. This decision was consistent with my treatment of other collections purchased by the University.

7. In my opinion, this practice was made necessary by the fact that individual items within a set were often expendable. For example, if a spoon went down the garbage disposal, it would not be treated as a capital loss because it was an expendable item. Similarly, when the University acquired a set of tools for research purposes, individual tools within that set were often sold to or purchased from the University by researchers, necessitating individual treatment.

8, I handled this transaction consistent with my normal practice. In selecting the proper account, it never entered my mind whether federally sponsored research was involved or whether indirect costs might be charged to the government.

I declare under penalty of perjury under the laws of the state of California that the foregoing is true and correct. Executed this 9th day of April, 1991, at Palo Alto, California.

Carolyn Morris
Carolyn Morris

Ralph Lawrence Norling
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(IRS FI 94-2719345)

January 3, 1985

Mrs. Margaret S. Dilg
Interior Design Consultant
Stanford University
623 Mirada Avenue
Stanford, Ca. 94305

Donation to Hoover House
Re Est of Alice Meyer Buck Oct 29 84

Dear Mrs. Dilg:

At your request, for the purpose of valuation appraisal, I examined the selected residential furnishings located in the Hoover House, Stanford University that were obtained October 29, 1984 as part of the items from the Estate of Alice Meyer Buck.

Appended are -

Conditions of this Appraisal

Appraisal Annex which describes this property in adequate detail to justify the Actual Cash Valuations.

This report fulfills our contract as of this date.

The fee is not contingent upon the values stated.

Respectfully submitted,

Ralph L. Norling

Ralph L. Norling A.S.A.
RLN:eh

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Conditions of This Appraisal

Actual Cash Value for Disposal

1. The values represent the Actual Cash Value considering the present physical condition of such items and the values normal to the used market in this area. The values reflect a reasonable disposal period (i.e. several weeks) with the "willing buyer - willing seller" connotation. Sales taxes are not considered.
2. The phrase "Actual Cash Value" has been determined by the Supreme Court of California to be synonymous with "Fair Market Value". See Jefferson Insurance Company vs Superior Court (1970) 3 Cal. 3d 398, 402
3. All statements contained in this Appraisal as to authorship, period, culture, source, origin, measurements, condition and relative value are qualified statements and shall not be deemed to be representations or warranties. These statements are made with the best of our knowledge and experience under the physical conditions of the examination.
4. No item is removed from any type framing or fixed container for examination.
5. We certify that we have no past, present or contemplated interest in this property and that this appraisement was conducted in accordance with the codes of ethics of those professional organizations in which we hold membership.
6. We assume no liability with respect to any action that may be taken on the basis of this Appraisal.

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January 3, 1985

Appraisal Annex

Property in the Hoover House obtained as part of the Estate of Alice Meyer Buck on October 29, 1984.

	Description	Actual Cash Value (ACV)
1.	Sterling beverage pitcher - Gump's, helmet form, ring foot, 9"	$ 125.00
2.	Pair of sterling platters - Vigueras, Mexico, hand wrought and hammered, plain, 11½"	200.00
3.	Sterling coffee pot - Shreve early 20th Century, octagonal taper slender, peaked cover, octagonal ring pedestal, "B" chased, 9"	225.00
4.	English George III sterling cup - w/o handle, hand wrought heavy fluted, chased rampant lion with trident, armorial, impressed hallmarks of maker: John Hutson, London 1800, 3½" D, 2½" H	400.00
4.	4 piece Victorian sterling tea service - c. 1900, maker not traced, heavy hand wrought repousse classic ornate bulbous with cartouche bow and swags, peaked pineapple covers:	
	Pot with large diameter swan neck, 8½" D	350.00
	Covered sugar bowl - 5½" H	200.00
	Cream pitcher - 4½" H	200.00
	Covered waste bowl with crown form top, 6½" H	200.00
5.	Sterling circular covered sweets bowl - Sanborn's, Mexico, heavy hand wrought, petal fluted domical cover, fluted body with floral repousse band, ring foot, 4 3/4" D, 3½" H	80.00

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January 3, 1985

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Appraisal Annex - Page 2

Property in the Hoover House obtained as part of the Estate of Alice Meyer Buck on October 29, 1984.

	Description	ACV
6.	German silver (800 fine) oval covered box - heavy hand wrought relief overall with oval figural farm couple, sheep and farm implements and floriate, gilt interior ring foot, 6½" L, 3½" H	$ 225.00
7.	Sterling oval basket - Gorham, pierced bulbous navette body, chased "M 1878-1903"	225.00
8.	2 piece sterling crumber set - Gorham c. 1900-15, "M" chased:	
	Crumber with 1 raised side with grip	75.00
	Side scraper - Chantilly	50.00
9.	Sterling hexagonal lobed rim deep bowl - Shreve, early 20th Century, pierced floral relief 6 pointed rim, 11½" D	400.00
10.	Pair of sterling pieces - Tiffany, heavy, reproductions of 18th Century American and English silversmiths, ring foot:	
	Cream pitcher - 3½" H, slender	200.00
	Open "Revere" bowl - 4" D	150.00
11.	Pair of sterling pieces - Shreve early 20th Century, octagonal body and pedestal ring foot, "B" chased:	
	Cream pitcher - 4½" H	125.00
	Covered sugar bowl - 5" D	150.00
12.	Pair of sterling pieces - Shreve, heavy relief Art Nouveau, "M" chased, pierced ring pedestal:	
	Pitcher - 6" H	150.00
	Open sugar bowl - 6" D	150.00
13.	Silver plated oval meat platter - Gorham, gadroon scroll rim, 21", few cuts	75.00

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January 3, 1985

Appraisal Annex - Page 3

Property in the Hoover House obtained as part of the Estate of Alice Meyer Buck on October 29, 1984

	Description	ACV
14.	Pair of European silver plated game cocks - fighting posture, 9" H, 11" L	$ 150.00
15.	Set of 12 sterling nut dishes - Gorham, early 20th Century, pierced, 3"	60.00
16.	Sterling child's cup - Geo. C. Shreve, heavy, floral repousse, chased "CHM 1893", 2½" H	40.00
17.	114 piece set of sterling flatware - Gorham 1903, Cromwell, each "M" chased, worn patina:	
	12 large dinner knives	300.00
	12 large dinner forks	420.00
	24 luncheon/dessert forks	480.00
	12 H/H spreaders	240.00
	9 salad forks	225.00
	9 teaspoons	180.00
	12 grapefruit	300.00
	12 luncheon knives	240.00
	12 F/H all sterling fish knives	300.00
	(Total $2,685.00)	
18.	Set of 12 sterling dinner forks - c. 1900 Shreve, plain, "M" chased	360.00
19.	Set of 11 sterling dinner forks - c. 1900 Shreve, "M" chased, bright cut floral chased	330.00
20.	Set of 10 sterling large coffee spoons - c. 1900 Shreve, "M" and bright cut floral chased	200.00
21.	Set of 11 sterling demi-tasse spoons - c. 1900 Shreve, "M" and bright cut chased	110.00
22.	Set of 12 sterling F/H spreaders - Shreve, Ramona, plain	240.00
23.	Set of 11 sterling salad/dessert forks - Reed & Barton from W.K. Vanderslice, "M chased, ornate floral	220.00

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January 3, 1985

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Appraisal Annex - Page 4

Property in the Hoover House obtained as part of the Estate of Alice Meyer Buck on October 29, 1984

	Description	ACV
24.	Set of 9 sterling large coffee spoons - W.K. Vanderslice Co., c. 1890, "M" chased	$ 180.00
25.	Set of 9 sterling F/H spreaders - Reed & Barton from Vanderslice c. 1890, "M" chased	180.00
26.	Set of 6 sterling large coffee spoons - c. 1900, Art Nouveau floral, "M" chased	120.00
27.	30 piece set of sterling flatware - Reed & Barton, "M" chased, gadroon:	
	18 teaspoons	270.00
	12 cocktail forks	180.00
28.	Set of 12 sterling ice cream scoops - c. 1890	240.00
29.	Various sterling flatware and serving pieces:	
	Large 5 tine serving fork - Reed & Barton, "M" chased	85.00
	Large fish side server - Reed & Barton, "M" chased	85.00
	3 piece set - Shreve c. 1900, "M" chased, spiral gadroon:	
	Scoop serving spoon	100.00
	Spade serving spoon	100.00
	Fish server	80.00
	Gravy ladle - Whiting, beaded, "M" chased	80.00
	Sugar/sweets spoon - Gorham c. 1800, "M"	40.00
	Sterling master spreader - Shreve c. 1900	30.00
	Dinner fork - Wm. B. Durgin Co. prior to 1905	35.00
	2 teaspoons	30.00
	1 F/H spreader	20.00

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January 3, 1985

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Appraisal Annex - Page 5

Property in the Hoover House obtained as part of the Estate of Alice Meyer Buck on October 29, 1984.

	Description		ACV
30.	Set of 21 Lenox porcelain soup plates - narrow encrusted gold rim	$	210.00
31.	15 piece Japanese porcelain tea set - mille fleur, some wear:		
	Octagonal platter		
	4 dessert plates		
	Covered sugar bowl and pitcher		
	4 eggshell porcelain large cups with 4 saucers		
	Total		75.00
32.	Wood folding ladder chair - c. 1920-30's, front legs fold to form steps		15.00

Totals -		
Silver	$	10,205.00
Other Items		300.00
Appraisal total	$	10,505.00

Ralph L. Norling
Ralph l. Norling A.S.A.

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TRANSMITTAL OF DEPARTMENTAL COLLECTIONS
TO CASHIER

Date: 11/16/87

Department: President's Office

Prepared By: Lisa Renton   Extension: 723-3419

Account Name	Account Number*	Amount
1. House Operations	7 882 002 94610	$ 1284.00
2.		
3.		
4.		
5.		
	Total:	$ 1284.00

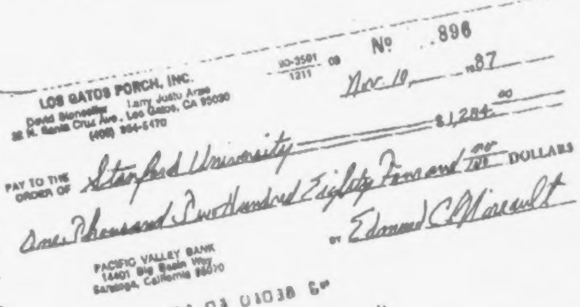
check

* Use complete 12-digit account number

For payment of:

Returned urns purchased at Los Gatos Porch. Please deposit into the account used for original payment.

Checks	$ 1
Currency	
Coin	
Total	$ 1284



LOS GATOS PORCH, INC.
David Bionestte   Larry Justu Arao
22 N. Santa Cruz Ave., Los Gatos, CA 95030
(408) 354-5470

90-3501/1211 00

№ ..896

Nov 10, 19 87

$ 1,284.00

PAY TO THE ORDER OF Stanford University

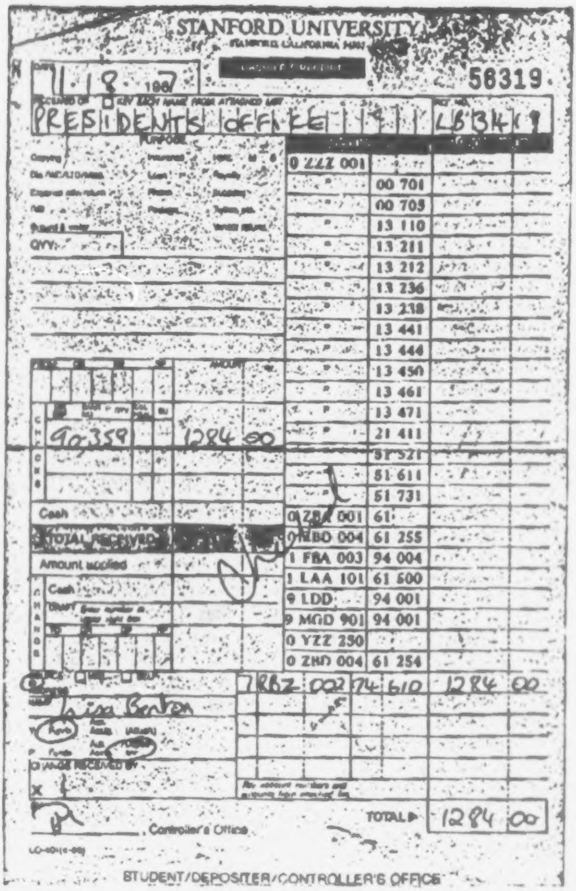
One Thousand Two Hundred Eighty Four and 00/100 DOLLARS

PACIFIC VALLEY BANK
14401 Big Basin Way
Saratoga, California 95070

BY Edmund C. Mirecault

121135919 03 01038 6

NOTE: (1) Please … be used).
Separat …
(2) Sales t … Excise Tax to be computed by department.



STANFORD UNIVERSITY

STANFORD, CALIFORNIA

56319

DATE 11 18 1987

RECEIVED OF PRESIDENTS OFFICE

REF. NO. LB314

QTY:

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7RBZ 002	74 610	1284	00

CHECK 90359 1284 00

Cash

TOTAL RECEIVED

Amount applied

CHANGE Cash

Draft

Lisa Benton

CHANGE RECEIVED BY

X

Controller's Office

TOTAL ▶ 1284 00

STUDENT/DEPOSITER/CONTROLLER'S OFFICE

Additional Information about the Urns

After the hearing, Stanford inquired further about the urns and determined the following:

When the urns were purchased in October of 1987, they were entered into the books as capital items, and therefore only depreciation was subject to inclusion in the indirect cost pool. When the urns were returned in November of 1987, however, the total amount of the urns was credited to an operations account, not a capital account. The result of this error favored the government; the indirect cost pool, in part allocated to the government in FY1988, included one-year's depreciation of the urns (or $128) and an off-setting credit for the entire amount of the urns ($1,284). Stanford's indirect cost study for FY1989 has not yet been submitted, and it will contain no charges for the urns.

In November, 1988, one year after the urns were returned, they were re-purchased from Los Gatos porch for $1200. The purchase was made during fiscal 1989, a year for which the indirect cost submission has not been made. No portion of the repurchased urns was ever charged to the government, and no portion will be charged in the future.

Note of correction: Chairman Dingell's opening statement mentions "a pair of George II lead urns at a 'special price' of $12,084." The price was $1,284 including tax (not $12,084, as indicated by Mr. Dingell).

FILE

Stanford University

OFFICE OF THE CONTROLLER

March 7, 1991

Doreen Eng
General Accounting Office
1275 Market St., Ste 900
San Francisco, CA 94103

Subject: Centennial Costs

Dear Doreen,

It is with great apologies that I finally respond to your oral request of 11/30/90 regarding how the Centennial costs were treated and whether they were for fund raising. As I orally responded to you, the 100th Anniversary of the founding of a non-profit organization like the University provides a time for celebration and reflection on the past and future as well as an opportunity for fund raising. Centennial Activities are being coordinated by two offices at Stanford University:

The Office of Development - for fund raising purposes, and;
The Public Affairs Office - for celebration and professional seminars.

In reviewing how we handled the Centennial costs, it is complicated in that new information requires changes going both ways. I have identified the accounts in which Centennial costs are collected, how they were handled and how they should have been handled.

The Office of Development

The Office of Development costs are contained in account 8TAC006 and 8TX. The 8TX accounts were opened in FY89, are all for fund raising and will be treated as unallowable. The 8TAC006 account was opened in FY87. No costs were incurred in this account in FY87 and therefore it did not have to be handled in the cost study for that year.

Based on the information provided to us at the time we were computing the actual costs for FY88, all of the 8TA accounts (including 8TAC006) were considered 55% allowable. Upon re-evaluation, OOD determined that the expenses in 8TAC006 should be

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treated as fund raising costs and excluded; and further that only 40% of the remaining 8TA's (excluding 8TAC006) should be allowable. With this adjustment, the allowable FY88 costs for the 8TA series of accounts should be $420,311 rather than the $1,074,523 as shown on the FY88 cost study. The calculations for this adjustment are shown on the attachment.

Office of Public Affairs

Costs of the Centennial are in 8UAA008 in the Office of Public Affairs. Costs are incurred in this account to commemorate and celebrate Stanford's history and focus on its future. This includes professional seminars where faculty members share research findings with others and discuss new research opportunities. In FY87, the first year in which costs were incurred, this account was excluded from the G & A pool; we see no explanation for the adjustment. In FY88, the costs were left in. In reviewing the purpose for the costs, we conclude they are allowable and allocable. Therefore, an adjustment to reinstate the 8UAA008 costs for FY87 in the amount of $461,129 should be made.

Call me if you have further questions.

Sincerely yours,

Janet

Janet Sweet
Assistant Controller

JDS:ks

cc: L. Horton
D. Zumwalt
G. Riden, DCAA
F. Reed

Office of Development Adjustment
for 8TAC006 Centennial Costs - FY88

	Per Cost Claim	Corrected Adjustment for 8TAC006
Total 8TA costs	$1,982,726	$1,982,726
Less 8TAC006		(924,459)
Adjusted 8TA	1,982,726	1,058,267
Less Equipment	(683)	(539)
Less Subsistence	(28,365)	(6,951)
Net 8TA costs	1,953,678	1,050,777
Allowable percentage	55.00%	40.00%
Allowable 8TA costs	$1,074,523	$420,311

Addendum to March 7, 1991 Letter of Explanation about Centennial Costs

As noted in the letter of March 7, 1991, Stanford has determined to treat Office of Development Centennial costs as unallowable fundraising.

Stanford also determined at that time that the Centennial costs for the Public Affairs Office in FY87 were legally allowable, as these costs were incurred to commemorate and celebrate Stanford's history and focus on its future, including professional seminars concerning research. Since the March letter, however, Stanford has decided that, even though legally allowable, we should withdraw these costs as inappropriate to include in a cost pool charged ion part to the government. The amount of the costs withdrawn is $461,129, and of that amount $105,600 was allocated to government organized research. Stanford will reverse its adjustment to the carryforward for that amount and adjust for similar costs in FY88. The university will provide the details of these adjustments to ONR and DCAA.

FINANCIAL RESPONSIBILITY AT UNIVERSITIES

THURSDAY, MAY 9, 1991

House of Representatives,
Committee on Energy and Commerce,
Subcommittee on Oversight and Investigations,
Washington, DC.

The subcommittee met, pursuant to notice, at 11:05 a.m., in room 2123, Rayburn House Office Building, Hon. John D. Dingell (chairman) presiding.

Mr. **Dingell.** The subcommittee will come to order.

Under the rules of the House of Representatives, this committee and its Subcommittee on Oversight and Investigations have specific jurisdiction over a number of matters; very specifically, biomedical research and development. This includes, specifically, research at universities.

On March 13, 1991, the subcommittee held the first of a series of hearings on universities mischarging and overcharging the Federal Government for scientific research. In that hearing, the subcommittee learned that Stanford University had charged taxpayers for everything from luxury yachts to 19th century Italian antique fruitwood commodes.

In fact, we heard testimony that Stanford may have overcharged the Government by as much as $160 million to $200 million over a 10-year period. We also learned that the Agency with oversight responsibility, the Office of Naval Research, was diligently asleep at the switch.

There have been significant developments in the matter of Stanford and its research and research billings since our last hearings. Through the excellent work of Mr. Paul Biddle, the Navy's administrative contracting officer at Stanford, and the aggressive auditing of the Defense Contract Audit Agency—and commendations should be extended to both Mr. Biddle and the DCAA—and coupled with the renewed support of the Director of the Office of Naval Research in late April, the Navy cut Stanford's 1991 overhead request by $28 million.

This means that $28 million more, in this one instance alone, can be spent on productive scientific research, rather than on overhead which goes to luxury items and matters not properly covered by Government regulations and by authorizations for research.

I should also mention that the Government has just received a check yesterday from Stanford for $924,517 as an initial repayment for overcharging the taxpayers for a wedding reception for the president, Lake Tahoe receipts, and enlarging the president's bed. Although this is but a downpayment on what Stanford owes for 10 years of overcharging and mischarging, it is clearly a step in the proper direction.

Very generally, it appears now that both the Government agencies with research oversight responsibility and the universities have gotten the message that there are limits to the tolerance of the taxpayers. I believe that the universities now understand that this is a new day and that all the overhead charges they make to the Government must relate to Government-funded research, rather than merely support for a country-club lifestyle, and I believe that the Government audit agencies are now moving aggressively to see that this is done.

It is my hope that the Government granting agencies, the agencies that authorize the expenditures of these public funds, will also have gotten the message and will see to it that proper cooperation is extended to the auditors, so that all may work in harmony to see to it that research is properly funded, that the taxpayers' concerns are considered, and that the broad public interest is well served. That will help us to assure that proper scientific research is properly funded according to the intentions of the Congress and according to the provisions of law.

Since the March hearing of this subcommittee, there has been a flurry of activity on the audit front. I said, in that hearing, that we expected universities from across the country to scrub their overhead charges. That process has begun. This subcommittee sent letters to 56 of the largest research universities asking about their plans in the aftermath of the subcommittee's hearings. The vast majority of those universities indicated that they had internal audits underway, most of them identifying significant unallowable and unreasonable charges to the Government.

I applaud what the schools have done, and I commend them for it. They have taken initiative, which is proper, to clean up their charges and charging practices before the audits begin. For example, Harvard Medical School deserves credit for initiating an internal audit 2 months before the Stanford hearing. Other schools, like MIT, have conducted no audits but have voluntarily pulled out embarrassing charges as the Government auditors asked for the records. That is also to be commended.

We will now look to see not only that the process of auditing proceeds but that the Government agencies responsible for these expenditures will carry out their responsibilities by commencing to change their regulatory and their staffing practices to assure that the abuses which the subcommittee has so far uncovered will not be repeated but also to lend a measure of public confidence that they will carry forward their responsibilities in a more suitable and appropriate and regular fashion.

Government audit agencies have been energized. Shortly after our hearing, the Navy announced that it was asking DCAA to audit all of the 41 universities it oversees. This is to be commended, especially since many of these universities have been barely audited, scarcely audited, or not audited. In addition, the Department of Health and Human Services announced that it was directing the Inspector General of HHS to audit 20 of its largest schools by the end of the fiscal year.

The hearing today will focus on the status of the audits and on interim findings which have come forward since the last hearing, and the Chair should observe, at this point, that this is not the last of the auditing nor is it the last of the hearings.

I will observe that, although it is true that early HHS and DCAA audits have not found yachts and fruitwood commodes, we have found a number of interesting things. Taxpayers have been paying for the expenses of a radioactive cadaver burial ground. They have been paying for executive jet services. They have been paying for trips to the Grand Cayman Islands for the wife of the university president. They have paid for a trustee's retreat at Palm Springs—that included cigars—and high legal fees to defend universities in Government investigations of wrongdoing at the universities.

The Chair should cite just a few examples of these charges, so that taxpayers can better understand what some of our major universities have been charging as the necessary costs of doing Federal scientific research.

Taxpayers were charged for the following items, amongst other things, at Dartmouth University, a great school of higher learning in the northeast: the operations and maintenance costs of what some believe is a haunted farmhouse, where radioactive cadavers and test animals are buried; some $20,490 for the chauffeuring of the president and his wife; travel expenses for the trustees, who donated their travel and have not received reimbursement; operation and maintenance costs for a building storing canoes and kayaks and a building used for pottery classes, as well as legal expenses to fight a U.S. Justice Department antitrust suit, a private antitrust suit, and a wrongful death suit involving a student.

Duke University charged the taxpayer for various expenses at its art museum, $3,780 for shipping and exhibition, $2,000 for putting together another exhibition, $1,890 for conservation services and housekeeping at the museum.

At MIT, taxpayers were charged for framing work at the MIT art museum, significant charges at a local jewelry store, a $4,655 contribution to the Museum of Fine Arts, the dues of the president at the Cosmos Club, and a $951.46 item for the deputy treasurer's trip to the Barbados, and the salary of the president's cook.

Another curious matter at MIT was its library study that supposedly justified charging 49 percent of its library costs to the taxpayers. The subcommittee staff, in a review, discovered that MIT had failed to include its undergraduates in the calculations. DCAA proposed dropping the rate to 34 percent, saving $1.5 million. The subcommittee staff then discovered that the Navy official who had approved this study, clearly flawed, had shortly gone to work with who? Guess. MIT.

At Cornell University, the taxpayers were charged for the construction of the new Cornell University club building in New York City, and in 1988 alone, $6,000 of charges at the Herman Weimer Vineyard and over $1,000 at Steuben Glass for wine glasses, presumably to drink this expensive wine; dinner at Mad Marvin's Seafood and payment of the president's library fines.

To top it off, the taxpayers were charged over $25,000 for the president to travel by chartered aircraft. The explanation? The president is a tall man, and he is uncomfortable in commercial aircraft.

For too long, Federal research funds have been treated as a cash cow for the universities. Auditing agencies have to be more vigilant in their oversight of indirect costs, and funding agencies have to be more vigilant in their oversight of both direct and indirect costs.

It must be observed that no clear pattern of behavior is defined by Federal rules and regulations and that there is no clear indication of proper behavior either to auditors or to the university from the agencies charged with making the grant.

This committee intends that abuses will end. They must end, and they will end. Taxpayer dollars must be used to support research not receptions and scientists not sailors.

There is a great need for proper support of education. There is special need for support of our colleges and universities, and I have always supported such expenditures.

There is a great need for seeing to it that science is properly supported. There is also a great need to see to it that the public has confidence both in the support and in the process and can have satisfaction that its Government is acting to see to it that its moneys are properly spent.

The Chair recognizes the distinguished gentleman from Virginia, Mr. Bliley, for an opening statement.

Mr. BLILEY. Thank you, Mr. Chairman.

On March 13 of this year, this subcommittee held its first hearing on the practices that a particular university, Stanford, had used in determining the indirect cost of performing research for the Federal Government. What we saw was not a pretty picture.

Stanford had included the cost of such items as improvements to the president's house, the administrative costs of operating a university-owned shopping center, and most notoriously, depreciation on its yacht in the pool used to calculate the indirect costs of doing research for the Federal Government. Though Stanford offered various excused for the expenses being included in the indirect cost pool, the persons who attended that hearing would have very little confidence that the system was working properly at Stanford.

Today, the subcommittee has before it representatives of two Government agencies that contract with universities to perform billions of dollars of research. Also present will be the agencies with audit cognizance.

The subcommittee will be interested in learning what has been done in the 2 months since the first hearing was held. We have learned that many universities have begun conducting self-examinations and have, as a result, withdrawn previously-submitted billings in the hundreds of thousands of dollars.

While this development is welcome, we must be sure that we learn what was in those withdrawn billings, since they should give us a clue as to the nature of the accounting system that permitted such billings in the first place.

I would also note that, in the withdrawal of these billings, I haven't seen any forthcoming attitude about paying interest on that money that was billed for previous years.

Wouldn't we all, as taxpayers, like it if, when the IRS sends us a letter that we owe them more money, that there was no interest or penalty for such underpayment of previous years' tax bills? These are things that we will want to consider as we pursue this.

In addition to the internal audits and reviews being conducted by the universities, the cognizant audit agencies have been conducting reviews. We should find out what these audits have discovered about the practices of universities as they place items in the indirect cost pool.

Our hearing in March showed that lack of adequate audit oversight had been partially responsible for the appalling situation at Stanford. From the Office of Naval Research and the Department of Health and Human Services, we seek to learn how all this activity has affected the indirect cost rates being charged to the Federal Government by the universities.

Have these indirect cost rates come down from the stratosphere? Have universities caught red-handed placing inappropriate items in cost pools been willing to live with more appropriate indirect cost rates, or has their attitude been one of defiance in an effort to find other items they can claim should have been placed in the cost pool?

Finally, we need to learn if there exists any potential legislative solution or assistance to this problem. Last Tuesday, the Subcommittee on Health and the Environment placed a 26-percent cap on the administrative expenses of universities doing research for the Federal Government.

I supported this measure but with reservations, especially since a cap could become a de facto target at which universities might take aim. I hope that our witnesses can instruct us about the possible implications of such a cap and help us understand how the Congress might be helpful.

Mr. Chairman, I commend you for your diligence in pursuing this matter and look forward to hearing from our witnesses today. Thank you.

Mr. DINGELL. The Chair thanks the gentleman.

The Chair recognizes now the distinguished gentleman from New York, Mr. Lent.

Mr. LENT. Thank you, Mr. Chairman. Earlier this year, this committee held a hearing that has continued to be a major topic of conversation, both on and off Capitol Hill. Wherever I go, people question me about the Stanford hearing, asking if we have uncovered further abuses by universities receiving research funding. We'll find that out today.

Subsequent to this subcommittee's initial investigation, other universities have taken the initiative to look at their books to see if they had overcharged or improperly charged the Government. To nobody's surprise, they had, because when no one is looking over your shoulder, it's easy to pad a bill just a little bit.

When it becomes apparent that your bill is going to be examined with a fine tooth comb, you're extra careful to ensure that everything is in order. So, we see that Stanford has voluntarily withdrawn $700,000 in previous billings, while others have followed suit; MIT, $731,00, Cal Tech, $500,000, the same at Harvard Medical School; Cornell, $310,000 and more than half a million at Washington University.

At Dartmouth, the university has just withdrawn charges for the president's chauffeur, a political forum on South African investment, as well as lawsuits against Dartmouth alleging that the university had practiced racial discrimination and had violated Federal antitrust statutes. I'm glad that these universities have responded promptly so that they may slowly begin to restore the public's faith and trust.

But this is only the beginning. I view our progress so far in terms of a poker game. The universities have just anteed up, and now the real game begins. The difficult negotiations, the tough scrutiny and painful decisions of allocating scarce research dollars still lie ahead of us.

We must remember, however, that this is not a game, not a game played with Monopoly money. Each year, the Federal Government spends more than $9 billion in research grants. Indirect costs eat up $2.5 billion of that total.

The Stanford hearing outlined flagrant abuses of the taxpayers' dollars, and subsequent investigations indicate that these abuses were not Stanford's alone. We must continue to pursue this matter until we are satisfied that Federal funds are being spent wisely. Then and only then will the public's faith be restored.

I must commend you, Mr. Chairman, for your leadership in exposing this problem and for moving swiftly to resolve it. There are no partisan differences on this issue. All of our constituents are taxpayers and they are outraged that they're paying for floral arrangements and ski weekends while the Federal Government runs unprecedented budget deficits.

Thanks to you, Mr. Chairman, and the work of this subcommittee and its very competent staff, this mess is beginning to be cleaned up. I just hope that America's universities realize that we'll be standing by with our brooms to make sure that they clean it all up. Thank you, Mr. Chairman.

Mr. **Dingell**. The Chair thanks the gentleman. The Chair does agree with the gentleman that there's been no partisanship in this matter, nor will there be. The Chair recognizes my good friend from Colorado, Mr. Schaefer.

Mr. **Schaefer**. I thank the chairman. I do not have an opening statement formally, Mr. Chairman, but I would just like to echo what the gentleman, the ranking member from New York has said.

I certainly applaud you for delving into this subject. Some of the items that you and the ranking member mentioned as far as being funded by taxpayers is just something that amazes, I think, everybody out there, including Members of Congress. I would hope that we continue to investigate this and delve into some of the solutions that are going to have to be made. I thank the chairman.

Mr. **Dingell**. The Chair thanks the gentleman. Our first panel is composed of the Honorable Kevin E. Moley, Assistant Secretary for Management and Budget, Department of Health and Human Services; the Honorable Richard P. Kusserow, Inspector General, Department of Health and Human Services, Mr. Gary M. Talesnik, Director of Grant and Contract Financial Management, Department of Health and Human Services. We also welcome you, Mr. Roslewicz and we thank you for being with us, also.

The Chair advises you, gentlemen, as you well know, that the practices of the committee are that all testimony is received under oath. Do any of you object to appearing under oath?

[Chorus of no's.]

Mr. **Dingell**. Very well, if you have no objection to appearing under oath, the Chair notes that copies of the rules of the House, rules of the subcommittee and rules of the committee are there before you to inform you of limitations of the powers of the committee, as well as your rights as you appear here.

The Chair advises that it is your right, since you are testifying under oath, to be advised by counsel. Do any of you so desire?

[Chorus of no's.]

Mr. **Dingell**. Very well.

[Witnesses sworn.]

Mr. **Dingell**. Gentlemen, you may each consider yourself under oath. We will recognize you first, Mr. Moley, for your statement, then Mr. Kusserow and the other of you gentlemen in such order as you choose.

TESTIMONY OF KEVIN E. MOLEY, ASSISTANT SECRETARY FOR MANAGEMENT AND BUDGET, DEPARTMENT OF HEALTH AND HUMAN SERVICES, ACCOMPANIED BY GARY M. TALESNIK, DIRECTOR, OFFICE OF GRANT AND CONTRACT FINANCIAL MANAGEMENT; AND RICHARD P. KUSSEROW, INSPECTOR GENERAL, ACCOMPANIED BY THOMAS D. ROSLEWICZ, DEPUTY INSPECTOR GENERAL

Mr. **Moley**. Mr. Chairman, I would ask that my full statement be entered into the record. I would like to provide a brief summary of that statement, if I may.

Mr. **Dingell**. That would be entirely appropriate, and we will recognize you for that purpose.

Mr. **Moley**. Mr. Chairman, the subject of your hearing today is one which has received a great deal of attention in recent days and months. Most importantly, actions are being taken to deal with problems in the current process and to focus on longer range solutions.

Specifically, the following actions have been taken to strengthen the current system: First, with the concurrence and support of Health and Human Services and other involved agencies, OMB has announced on April 22, new policies aimed at stopping some of the specific abuses arising from application of the current rules in Circular A-21. This is an initial step and more other interim steps, as well as comprehensive reforms to indirect cost policy are being considered.

Second, increased audits of indirect costs are being made by both Federal and non-Federal auditors. The Inspector General has a number of such audits currently underway. Also, OMB, under Circular A-133 guidelines, will require non-Federal auditors to give substantially greater attention to this area than in the past.

Third, on April 10, the Inspector General, in cooperation with this committee and my office, issued a special notice on this subject to the presidents of the major universities under HHS cognizance, approximately 120 schools. This notice urged the chief executives of these institutions to review their procedures to ensure that only allowable costs are included in their indirect cost proposals and to advise the Department if the review found any unallowable costs. Feedback from the field indicates that most of the institutions are in the process of conducting these reviews.

Four, improvements are being made in our indirect cost negotiation operation. These include consolidation of our negotiation offices, issuance of a comprehensive guide for reviewing university indirect cost proposals, and the use of specialized consulting services to aid the negotiators in their reviews of certain parts of the proposals.

Finally, from a longer term perspective, Dick Kusserow, who is our Inspector General, our NIH Director, Dr. Bernadine Healy, and I have formed a working group to examine the entire problem of the cost of research, including the spectrum of issues related to indirect costs. This group has begun its work and has agreed upon its basic operating principles.

These developments are a reasoned approach to change in this most important area. Collectively, I believe they will result in real improvements in the way we do business. I appreciate this opportunity to appear before the subcommittee and I will be glad to respond to your questions. Thank you, Mr. Chairman.

[The prepared statement of Mr. Moley follows:]

STATEMENT OF KEVIN E. MOLEY, ASSISTANT SECRETARY FOR MANAGEMENT AND BUDGET, DEPARTMENT OF HEALTH AND HUMAN SERVICES

Mr. Chairman and Members of the Subcommittee: I am Kevin E. Moley, Assistant Secretary for Management and Budget.

I am pleased to be here to discuss my office's role in indirect costs. This subject is of particular importance to the Department since indirect costs represent almost a third of the total costs of the Department's research grants. Additionally, from a broader perspective, we are responsible for negotiating indirect cost rates on behalf of all Federal agencies for the vast majority of colleges and universities receiving Federal research funds. HHS therefore has a major role in assuring that the indirect cost process works effectively.

I hope that some general background information on indirect costs will be useful.

Indirect costs (also called "overhead") are the costs institutions incur for administrative and supporting services which cannot be identified to individual research projects or other programs. Although these costs cannot be identified to specific programs, they are nonetheless allocable to certain operations of the institution and the performance of its programs.

Typical examples of indirect costs include the salaries and expenses of the institution's top management; financial and administrative services, such as accounting, purchasing and facilities; depreciation on buildings and equipment; etc.

Federal programs pay a share of the institution's overall indirect costs. The amount is determined by a cost allocation process that measures the portion of the indirect costs that are allocable to Federal programs. The end product of this process is an indirect cost rate. For example, if an indirect cost rate for research programs conducted by a university is 50 percent of total direct costs, this means that for every dollar of direct research costs the university receives it also receives 50 cents for the indirect costs allocable to the programs.

OMB issues guidelines (called "cost principles") on how indirect cost rates should be negotiated and what costs are "allowable." In the case of colleges and universities, these guidelines are in OMB Circular A-21. Similar guidelines have been issued for other types of organizations, such as State and local governments and other nonprofit organizations. OMB Circular A-21 was last revised by OMB in 1986 and was initially published in 1958.

The ratio of indirect costs to direct costs was 46.4 percent for NIH research grants awarded to universities in fiscal year 1990. This ratio has been relatively stable for a number of years (in 1986, it was 46.2 percent). In dollar terms, the indirect costs awarded to universities under NIH research grants in fiscal year 1990 were approximately $1.25 billion. An exact Government-wide amount is not available, but is likely in the range of $2 to $2.5 billion.

With that as background, I would now like to discuss how indirect cost rates are computed and negotiated.

In addition to the government-wide cost principles established in A-21, OMB has also established a system for review and negotiation of indirect cost rates with universities. Under this system, each university is assigned to a single Federal agency which performs the function. The agency responsible for this function is referred to as the "cognizant agency." The resultant indirect cost rate that is negotiated is then used by all Federal agencies. As I noted earlier, HHS is responsible for most of the institutions, although some of the major schools, such as Columbia, Stanford, and MIT, are assigned to the Department of Defense.

Negotiations of the rates are based on indirect cost proposals the institutions submit to the cognizant agency. These proposals detail the allocation of each indirect cost component to the institution's major functions—primarily, research, instruction and public service. Then the total amount of indirect costs allocated to the research function is divided by the direct costs of the research to compute the indirect cost rate. For example, if $12 million of indirect costs are allocated to the research function, and the direct costs of the research are $20 million, the indirect cost rate would be 60 percent. Similar computations are made to determine the indirect cost rates for the other functions of the institution.

The indirect cost proposals submitted by the institutions are reviewed and negotiated by the cognizant agency. HHS' system for doing this involves a staff of cost negotiators located in Washington and in our regional offices. They specialize in reviewing and negotiating indirect cost proposals. All of our negotiators are professional accountants, and the senior people who handle the larger cases have many years of experience in evaluating and negotiating indirect cost rates. The reviews of proposals from the major institutions frequently involve a site visit to evaluate certain aspects of the proposal on-site, and, in some cases, may involve an audit of the proposal.

The negotiations are conducted with financial officials of the institutions, such as the controller or vice-president for finance. Most of the negotiations ultimately result in an agreement on the rate between the Department and the institution. If an agreement cannot be reached, the Department will issue a unilateral notice and the institution would then have the right to appeal under our appeals regulations. The final administrative appeal authority in HHS is our Departmental Appeals board. If the Board rules against the institution, it has the right to go to Federal court; but this is rarely done.

The basic process for determining indirect cost rates has evolved over a number of years. As with any system, there are areas where improvements could be made. In this regard, the Department has initiated several actions to strengthen the current system.

First, at the request of the Secretary, Dr. Bernadine Healy, Dick Kusserow and I have jointly formed a top level working group to examine the cost of research. Prime among our focus areas is the entire spectrum of indirect costs issues and their relation to direct costs and the ultimate cost of research as directed by the House and Senate Appropriations Committee for fiscal year 1991. The new NIH Director is reviewing a draft cost management plan. Our work on indirect costs will complement that effort.

Second, increased audits of indirect costs will be made by both Federal and non-Federal auditors. The Department's Inspector General has a number of audits and reviews of indirect cost underway. These focus on an institution's cost proposals and support the indirect cost negotiation process. As part of this effort, the IG will audit individual expense transactions to ascertain the extent of problems similar to those found at Stanford. Also, OMB has guidelines currently under development which will require non-Federal auditors to give further emphasis to this area.

Additionally, over the past few years, we have initiated a number of improvements to the Department's indirect cost negotiation operation. These initiatives include:

—A consolidation of our negotiation offices;

—The issuance of a comprehensive guide for evaluating university indirect cost proposals;

—The use of special team reviews of proposals from certain major institutions; and

—The use of specialized consulting services to assist the negotiators in their reviews of certain technical aspects of proposals.

The consolidation of our regional negotiation offices is expected to significantly strengthen the negotiation activity since it will provide a broader level of expertise in each office. This is needed to effectively handle the wide range of cost proposals the negotiators are required to review and negotiate. This consolidation was announced in 1989 and will be fully implemented by the end of this fiscal year.

The guide for evaluating university indirect cost proposals was completed last summer. It further refines and directs the special team reviews which were begun in 1986. Both are also designed to strengthen the quality of the reviews and negotiations conducted by the negotiators, especially for the larger, more complex cases.

Finally, we are in the final stages of contracting for specialized consulting services to assist the negotiators in evaluating certain technical areas that impact on the allocation of indirect costs. Services are being sought for actuaries, statisticians and engineers. For example, the use of engineering consultants will strengthen our scrutiny of studies allocating utility costs between research laboratories and classrooms.

That concludes my prepared statement, Mr. Chairman. I hope it was useful to the subcommittee and will be glad to respond to any questions you may have.

Mr. **Moley**. I'd like to add that I have with me, on my left, Mr. Gary Talesnik, a distinguished career official of our Department, who is the Director of our Division of Cost Allocation. Thank you, sir.

Mr. **Dingell**. We do welcome you. We thank you very much, Mr. Secretary. First of all, I thank you for your very helpful statement. The Chair does note that as we go through these matters, we will be, of course, looking for the development of a continuing policy within the Agency with regard to these expenditures.

At a further time, we have a hearing which will be very much focused on that particular matter as we proceed. Mr. Kusserow, we are happy to welcome you.

TESTIMONY OF RICHARD P. KUSSEROW

Mr. **Kusserow**. With me is Thomas Roslewicz, our Audit Director for HHS. I want to thank the committee. In particular, if you will look on page 14 of our testimony, you will see that suddenly we're having an early engagement with universities, that suddenly we're having a lot of them come forth with suggestions as to how they might reduce their own indirect cost pools.

I will tell you that that is unique in my experience of 10 years as the Inspector General for the Department. I do not think it's uncoincidental to the hearings that you had on Stanford that this has occurred. Indeed, I think we are also evidencing the results of this committee, and for that, I thank you very much.

With your permission, I'd like to, as with Mr. Moley, submit my full statement to the record—it's rather lengthy—and perhaps just highlight a few points.

Mr. **Dingell**. That would be entirely acceptable, and you may proceed in that fashion.

Mr. **Kusserow**. Mr. Chairman, Federal funding for science at colleges and universities is approaching $10 billion a year, of which in excess of a quarter of a billion dollars now goes for indirect costs or unallocated overhead. The remaining money goes for direct research costs.

Audit and cost negotiation responsibility, as you have pointed out in your opening comments, is really the cognizant that is assigned the responsibility for the institution. Of the 276 colleges and universities that receive the lion's share, 96 percent, of Federal funds, 39 are under the cognizance of the Department of Defense and the balance, 237 are assigned to our Department.

Over the years, we have raised serious concerns about the amount of Federal funding that is being diverted to indirect costs at the hosting school. As you pointed out again, every dollar that goes to the unallocated overhead or indirect costs, is one less dollar that's used for direct research. We're saying we have one pot of money and it's a question of how you divide that pot up. Every dollar going for overhead at the university is one less dollar that goes to direct research.

Sometimes in the discussion with people from the university community, they seem to fail to recognize that is the end result. It seems to me that—and just making an overview comment—there's a underlying irrationality about the way we are doing business with the universities that host Federal Government sponsored science.

The original collegiality that was behind the funding of science was to involve three parties—scientists who do research, universities that would host that research, and the Federal Government that would underwrite that research. Somehow, that is not the way it's working today. We actually have four parties.

We have the scientists coming for approval for new proposed research, and then somehow we have a new team that comes in that are unconnected and that are the accountants, auditors, to try to determine separately what the indirect cost rates should be for the hosting institution. What we, in fact, have now, it seems to me, Mr. Chairman, is a full employment act for accountants, auditors and lawyers.

I'm not sure that this is really what was originally intended. The whole process really takes on a sense of gamesmanship here. That is, and you heard it at your Stanford hearing when you had the auditor for Stanford suggest that, of course, they advise their clients to get as much as they can in the indirect cost pools. That's the way—that's good accounting.

That may be good accounting, but the question is whether that is good public policy. As Mr. Moley had indicated, the Department has a task force that involves the—for Management and Budget, the Director of NIH and the Inspector General. We're just trying to review the relationship that we have with these parties and to see if, in fact, we can find a better way in the future to do business.

However, currently, the audit oversight of universities is governed by OMB guidance. In particularly, you will have noted A-21. This is a process that really starts with independent audits performed at the universities. Then the second line of defense comes in where those audits and their working papers are reviewed by the Office of Inspector General Auditors.

The third line comes in where the auditors of the Office of Inspector General go ahead and do audits at the universities. The audits that we perform are generally of two types: those that are in support of ASMB's cost allocation effort and negotiation, preaward, if you will, and then those that are coming after the fact that look at what actually has occurred in that process.

I think you will hear a lot from this panel about the fact that we feel that we've made a very substantial effort in this arena and that we have rightfully some pride in the end result that has our indirect cost rates at a much lower figure than other cognizant agencies.

In the testimony that I submitted for the record, I did note that there are a lot of different things that are available for consideration by the Congress and by the administration in trying to examine what our relationship should be.

One, of course, is going back to Circular A-21, which are the cost principles for educational institutions, and to see if we can strengthen them in some way. Already, OMB, as Mr. Moley pointed out, has taken efforts to strengthen it.

Among the things they're going to be doing is, in the new proposed clarification of A-21, is to prohibit reimbursement for entertainment, prohibit university officers' housing and personal expenses, or luxury travel, or promotion and lobbying, or golden parachute or excessive salaries. The fact is, Mr. Chairman, those things were permissible and were argued when we went out to the universities to challenge them on what they were putting in the indirect cost pools.

It's a step in the right direction; however, I don't think there's anybody who would say that that is the end. I think what we really need to look at are some other things that we can do to better improve the way we do business.

There are a lot of things that we put in there as possible options for further considerations, including such things as maybe giving the money to the principal investigators and saying let them negotiate indirect cost rates, or certainly mandating a standardized accounting system.

One of the things that causes us a great deal of concern, Mr. Chairman, is that we do not have standardized accounting at the universities, which means that you're oftentimes comparing apples to oranges, to pears to peaches.

If you have standardized accounting, then the old notion of squeezing the balloon—that is, cracking down on one part of the indirect cost pool and not having it be squeezed out to another part, or squeezed from the indirect cost pool into the direct cost pool—we certainly could limit that kind of gamesmanship.

There are proposals in consideration for somehow capping of components of the indirect cost rate or perhaps the indirect cost rate itself, or mandating cost sharing for research, or limit the indirect cost to only those expenditures which are an add-on burden to the university for hosting science.

We could also talk about not charging the Federal Government an indirect cost rate any higher than you charge anybody else—the lowest charge rate should be to the Federal Government—or talk about maybe the granting agencies negotiating their own rates with hosting institutions.

One of the other things that Mr. Bliley pointed out, and that is that I have to tell you that the notion that somebody could spend money inappropriately and keep that money without returning it is bothersome, but even when they do return it, it seems to me they should return it to science, and that they should do it with interest. It should be at a rate that certainly covers the cost of inflation during the period. I don't see why we can't do it.

One of the points I make in my testimony is a concern that we have, and that is, if we do get money back, it goes into the general fund, it does not go back to science. But generally speaking, the way the process works is that if you find that there are inappropriate expenditures in the indirect cost pools, you roll forward the savings into the future rate, and so it's really an offset to the future.

So generally speaking, a vast majority of questioned costs really stay on campus. I don't think that's a disincentive to trying to fudge the pool. I think that they should have to give that money back, and I think it should be done with interest.

With those points in mind, I would just add there are other things that could be done, and I think it's probably my last choice, and it may sound peculiar. That is, you could always increase the funding, but having more auditors and more accountants to meet the auditors and accountants of the universities, and I think that I would take that as a last choice. In fact, we should try to improve the relationship we have with universities hosting our research rather than adding more people to play the game, because no matter what happens, the universities will have always more accountants, auditors and attorneys available to them than we would. So I would hope that we could find a better way to do business.

With that, Mr. Chairman, I'd like to reserve whatever time remains to answering any questions that you or the committee might have.

[Testimony resumes on p. 321.]

[The prepared statement and attachments of Mr. Kusserow follow:]

TESTIMONY

OF

RICHARD P. KUSSEROW

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Good morning, I am Richard P. Kusserow, Inspector General of the Department of Health and Human Services. We are here this morning to discuss with you our experiences in auditing expenditures made under Grants and Contracts awarded to Colleges & Universities and to update you regarding our oversight of this area. We will summarize our recent audit experiences at schools across the country. As you know, we initiated many of these audits shortly after your hearings on indirect cost matters at Stanford University. Finally, we would like to present some options for improved administration and Federal oversight of these costs.

Background

To provide this subcommittee with background information and to help place this issue of indirect costs in proper perspective, we would like to include in the record a report that I an releasing today, entitled, Federal Funding to Colleges and Universities in Support of Research.

Federal Funding

Colleges and universities are increasingly dependent on the Federal government for funding to conduct research, particularly biomedical research. Since 1984, total Federal research and development obligations to colleges and universities have increased from $5.6 billion to the current level of over $9.2 billion. This represents an increase in funding of 64 percent. Indirect costs provided to colleges and universities over the same period have increased from $1.5 billion in 1984 to $2.5 billion.

A majority of the research grant money comes from the Public Health Service (PHS) of the Department of Health and Human Services (HHS). The National Institutes of Health (NIH) funding alone accounted for $3.9 billion in Fiscal Year 1990, of which $1.25 billion was for indirect costs. Appendix A depicts the growth in NIH research costs from 1980-1990, showing growth in both direct and indirect costs. For FY 1991, NIH has provided for $3.7 billion for extramural research, of which $1.7 billion will pay for indirect costs, approximately 46 percent.

There is good reason to believe that colleges and universities dependence on direct and indirect costs for research will continue for the foreseeable future. Fiscal constraints and increasing competition for budget dollars are resulting in pressure to increase the amount of money applied to direct research rather than to indirect or unallocated overhead costs. As an aside, it is interesting to note that the indirect costs for research funded in Fiscal Year 1990 by NIH exceeded the amount spent on AIDS research. Similarly, the amount anticipated for indirect costs for all NIH extramural grants in 1991 will exceed the total budgeted for cancer research.

OMB Guidance

There is a concern that the relationship between the Federal government and the university world is a very loose one. We believe that nothing could be further from the truth. Federal guidance from both OMB and the individual funding agencies is voluminous, complex, and detailed. Government-wide instructions issued by OMB address virtually all aspects of Federal funding of university and nonprofit institutions. This guidance--issued in the form of OMB Circulares--is binding on all parties. Appendix B provides a summary of applicable OMB Circulares.

There are three general aspects of Federal guidance which are necessary to understand the current situation. These are Cognizance (assignment of oversight responsibility to agencies), Indirect Costs, and Audit Requirements. Each is addressed individually below.

Cognizance

OMB Circular A-88 generally assigns cognizance responsibility for colleges and universities, to the Federal agency with the largest sum of money represented at the school. Over 90 percent of the colleges, universities, and nonprofit organizations involved in research receive most of their Federal funding from HHS and, therefore, fall within our cognizant responsibility. The other major cognizant agency is the Department of Defense (DOD), which is assigned cognizance for 35 major schools. Appendix C reflects the distribution of responsibility between HHS and DOD for the 20 schools which receive the most research dollars. Audits are performed directly by the cognizant agency (at HHS, the OIG) through private sector auditors. Non-Federal auditors review financial and compliance issues at colleges, universities and nonprofit organizations in accordance with OMB guidance. The auditors are required to include within their scope of work, the indirect cost pools charged to the Federal Government. Federal auditors in the cognizant agency review their work to assure that it has been performed according to audit standards and to identify issues warranting follow-up.

Direct and Indirect Costs

The total cost of any research project is divided into direct and indirect costs. Direct costs are those that can be identified specifically with a particular sponsored project, instructional activity or any other institutional activity; or that can be assigned directly to such activities with a high degree of precision. Examples of direct costs include salaries and wages of those working on the projects, laboratory supplies, equipment, subcontracts and any other direct overhead expenditure. Modified Total Direct Costs (MTDC) is an important subcategory of direct costs. It usually includes all direct costs except equipment and that portion of subcontract costs in excess of $25,000. Modified direct costs are significant because they are the basis used to determine the extent to which indirect costs are assigned to individual Federal grants and contracts.

Indirect costs include those costs that have been incurred for common or joint objectives of the university including the research effort housed at their facilities. They cannot always be identified readily and specifically with a particular sponsored project, or institutional activity. Examples include utilities, common space, and library expenses.

OMB guidance (A-21) provides to colleges and universities, as well as Federal agencies, the principles for determining the costs applicable to research and other work performed under federally sponsored agreements. The principles do not attempt to identify the extent of agency and institutional participation in financing the costs of a particular project. Rather, they were designed so that the Federal Government would bear only its fair share of total costs, determined in accordance with generally accepted accounting principles, except where restricted or prohibited by law.

The principles in A-21 for Federal grants were established over 30 years ago when the research environment and Federal funding were less complex. They have been modified only 8 times over the years, and, in our opinion, A-21 has not kept pace with changes in the scientific research arena and with today's business and accounting practices. By contrast, the Federal Acquisition Regulations (FAR), relating to contracts, are modified almost monthly to keep up with problems and changing business practices.

In 1985, the issue of indirect costs for research again arose. The OIG was asked to study the reasons for the dramatic increases in indirect costs for research funded by the department. We looked also at the legitimacy of indirect costs. In response to our report, the HHS Assistant Secretary for Management and Budget, OIG, the Office of Science and Technology Policy and OMB recommended changes to the principles (A-21). We recommended that: (1) the amount of departmental administration expenses chargeable to sponsored research be established at a fixed allowance of 7 percent of the direct cost of research; and (2) the use of multi-year predetermined indirect cost rates be expanded. Now, in 1991, we are again working closely with other

Departmental officials, OMB, and the Congress to review the effectiveness of Federal controls over research costs.

In 1988, in response to the growing concern over indirect cost issues, the Executive Committee of the Association of American Universities (AAU) charged an ad hoc committee, to review the current system, particularly OMB guidance (A-21) and to identify suggestions for change. According to the Committees's draft report, the entire context in which the indirect cost system operates is changing. Important changes include pressures on university faculty, cumulative effects of conflicts between research faculty and university officers over indirect costs, increasing obsolescence of research facilities and equipment, and the basic relationship between universities and the Federal Government's support of research.

The Department's process and experience with indirect cost is important. The weighted average indirect cost rate for major research universities negotiated by HHS has remained fairly stable at 48 percent in 1985 to about 51 percent in 1991. Appendix D shows the weighted average indirect costs from 1982 to 1991. It also shows that portion of the overall rate attributable to the various cost centers that make up indirect costs.

Many schools over this period have requested significant increases in their indirect cost rates. The Division of Cost Allocation (DCA) within HHS reviews and negotiates indirect cost rates proposed by the institution. The negotiation process is important to ensure that the maximum number of Federal dollars are used for research expenses and activities. Our audit staff may be called upon to support this work.

The Department's effort has greatly limited the rise in indirect costs at HHS cognizant schools. To place this effort in perspective, the average indirect cost rate proposed by the schools for HHS cognizant colleges and universities is 58.57 percent. The negotiated rate for these same schools is 50.99 percent, a difference of 7.58 Percent. This difference yields estimated annual savings of $200 - $300 million.

The following table illustrates the impact of negotiations on establishing indirect cost rates. The table includes a geographic spread of "high dollar" schools and a summary of all schools negotiated.

Institution	Percent indirect proposed	Percent cost rate negotiated	Percent 1990 decrease	1991 proposed indirect rate*
Howard University	155	75	80	122
Harvard				
Medical School	98	77	21	104**
University	78	68	10	86
Johns Hopkins University	74	64	10	74
UCLA	48	46	02	63
University of Washington	70	51	19	66
Washington University	62	60	02	64
Overall 1990	59	51	08	59

* final rates have not yet been negotiated, as of April 1991.

** Harvard's original proposal was for 104 percent. They subsequently made adjustments which resulted in a proposal of 94 percent.

The approximate savings that result from a single percentage point reduction of the mean indirect cost rate nationwide is $43 million. This amount is based on calculations using figures from 119 major institutions including 19 institutions negotiated by the DOD and includes a number of assumptions. The indirect cost associated with the 119 major institutions includes 90 to 95 percent of all indirect cost paid to educational institutions.

The savings that result from indirect cost rate changes at individual institutions vary widely depending on a number of factors, such as, the indirect cost rate, the amount of Federal research paid to the institution and the amount of indirect costs claimed. Based on national averages, the savings per point at individual institutions amounts to about $46,000.

In our opinion, the current version of OMB guidance (A-21) does not provide incentives to schools to minimize or contain costs allocated to Federal research projects. Basically, A-21 permits universities to charge expenses to Federal research when those expenses are allowable, allocable, and reasonable. Costs are considered reasonable "if the nature of the goods or services acquired or applied, and the amount involved therefore, reflect the action that a prudent person would have taken under the circumstances prevailing at the time the decision to incur the cost was made." This subjective test of reasonableness provides great latitude for schools to include many items and services which might otherwise be excluded under the more specific Federal acquisition regulations. A cost is allocable to a specific project if "the goods or services are chargeable or assignable to such cost objectives in accordance with relative benefits received or other equitable relationship." Again, the non-specificity of A-21 provides discretion and, indeed, incentives to schools to define "benefits received" to their best advantage.

Both OIG and non-Federal auditors, when engaged in reviews of grants and contracts at colleges and universities, must rely on A-21 for Federal policy regarding the allocability, allocability, and reasonableness of charges. Clarification of this policy would enhance the auditors' effectiveness in their oversight role.

Audit Requirements

In 1979, the House Committee on Government Operations and the Government Accounting Office (GAO) released a report criticizing the auditing of Federal grants to colleges and universities calling it haphazard and ineffective. At that time, colleges and universities were responsible for doing school-wide audits of Federal funds (A-110). (A-102P applied the same requirements for State and local governments.) Each Federal agency usually audited only its own grants, without coordinating with other agencies providing funds to the same school. To correct this inefficient approach to audits at colleges and universities and redirect scarce HHS audit resources to the Medicare, Medicaid and social security programs, OMB developed single audit policy which we supported. We demonstrated the value of the single audit concept by conducting 30 pilot audits over 3 years. The major outcome of the pilot projects was the development of guidelines for single audits in colleges and universities. The Federal inter-agency task force, chaired by OMB, endorsed use of the guidelines.

In April 1984, We testified before the Committee on Government Operations that colleges and universities were reluctant to accept the single audit guidelines. Thus, we recommended that legislation be enacted to require this practice, more specifically, we recommended that the Single Audit Act be amended to cover colleges and universities, as well as State and local governments. This proposal was not enacted. However, these principles are now included in revised OMB guidance (A-133).

Until January 1990, OMB guidance (A-110, Attachment F) contained provisions for organization-wide audits at colleges and universities. However, the Circular was proven to be inadequate because the audit requirements lacked sufficient detail and did not require that such audits be done in accordance with generally accepted government auditing standards. Further, it did not require the schools to submit the results of their audits to the Federal Government for review.

In response to these perceived inadequacies, OMB issued revised guidance (A-133) for the audits of institutions of higher education and other nonprofit institutions to strengthen audit requirements. Our office worked closely with OMB to develop A-133.

A-133 established audit requirements and defined Federal responsibility for colleges and universities and otherwise addressed previous deficiencies. Appendix E describes the responsibilities of colleges and universities, and the OIG under A-133. This new guidance, applicable to audits for fiscal years that begin on or after January 1, 1990 requires that schools have an audit of Federal awards every 2 years. The full implementation of this circular will substantially increase and improve audit coverage at these institutions.

Audit Findings and Lessons Learned

Since the establishment of the Audit Agency, in what was then the Department of Health, Education and Welfare, it has performed thousands of audits in colleges and universities. For the 42 month period ending in March of 1991, 2052 audits were performed either directly by our staff or through non-Federal auditors. The OIG staff performed 547 of these audits which consisted of

207 preaward contract audits, 269 audits of costs incurred on grants and contracts and 71 special studies and reviews of direct or indirect costs.

Over 85 percent of the findings uncovered during these audits involved internal control problems related to specific cost elements or activities. Over 2200 such problems were identified. Internal controls in an organization involve the overall plan of organization and methods employed to ensure the reliability of accounting data, safeguard assets, promote efficiency, and ensure compliance with established policies. Many of the internal control problems uncovered have cost implications. Specific examples of internal control findings and other findings in cost and program specific areas are included in our report, Federal Funding to Colleges and Universities in Support of Research, which has been submitted for the record.

The audit findings we have uncovered over the years have provided us with many insights into the problems in funding research at colleges and universities and led to our development of a "Long Range Strategy for Reviewing Financial and Programmatic Research Activities Conducted by Colleges, Universities and Non-profit Organizations for the Federal Government." We are also submitting a copy of this strategy paper for the record.

Indirect Cost Audits at 13 Schools

As part of our strategy we have reviews underway at 13 schools focusing on charges to indirect cost centers. These reviews were begun subsequent to this Subcommittee's hearings held in March 1991, which revealed unallowable and unreasonable charges to Federal research by Stanford

University. I can report to the Subcommittee that our reviews, which are still underway, have also found numerous charges which we believe to be inappropriate. Although we have not found charges for a yacht or antique commodes, we have found that schools are charging research accounts for a portion of unallowable or inappropriate items. Following are some examples of such charges at the schools we are currently reviewing. We have included as Appendix F a more complete list of examples of unallowable or inappropriate charges.

- Receptions and catered dinners including rentals of tents, liquor, balloons and valet parking.

- Legal expenses for law-suits unrelated to research. For example, at one school Federal research was charged for a portion of the expenses related to an antitrust suit by the Justice Department.

- University Presidents' travel for matters unrelated to research. For example, at one school research was charged for airfare for the President's wife for trips to Grand Cayman Island and Sarasota Florida. (The President reimbursed the University for these expenses about a week after our audit began and more than one year after the trips were made.)

- Items classified as "special merchandise" in the accounting records which turned out to be liquor.

- Private club memberships including golf clubs.
- Engraved crystal decanters from Neiman Marcus.
- A sculpture that had already been paid for by a contributor to the school.
- Mailings and other expenses related to alumni activities.
- Expenses related to Presidents' houses, including flowers, chauffeurs, travel, gifts, cleaning supplies and other maintenance.

I can also report to this Subcommittee that a number of the schools we have visited have initiated reviews of indirect cost charges on their own and have volunteered to remove certain charges from cost centers which are eventually allocated to Federal research. The total amount identified to date at these schools, both by the school itself and our auditors, is about $14 million. As shown below, we have preliminary results from 12 of the 13 schools.

Summary of Preliminary Results

Institution	Amount of Unallowable/ Inappropriat Indirect Costs In Cost Pools*
Dartmouth	$ 1,066,432
Yale	$ 720,186
Rutgers	$ 4,894,845
Johns Hopkins	$ 175,183
University of Pennsylvania	$ 941,476
University of Pittsburgh	$ 259,085
Duke	$ 906,245
Emory	$ 672,557
University of Michigan	-0- **
University of Chicago	$ 348,050
University of Texas Southwestern Medical Center at Dallas	$ 32,537
Washington University in St. Louis	$ 985,000
University of Southern California	$ 3,112,150
TOTAL	$14,113,746

*Includes voluntary reductions by the schools and/or reductions based on OIG review. In most cases, OIG work is still in process and results are incomplete.

**University of Michigan has not made a review to reduce cost pools.

In addition to the above, we are aware that Harvard University Medical School, another institution under our cognizance, has agreed to remove about $500,000 from indirect cost centers charged to Federal research. As you know, the General Accounting Office is currently reviewing this matter at Harvard. We have also been advised that at least four schools under the cognizance of the Department of Defense--Stanford, Massachusetts Institute of Technology, California Institute of Technology, and Cornell--have agreed to reduce indirect costs.

We are concerned that the only schools under our cognizance that have volunteered to make adjustments are those which we, or other Federal officials, have visited. Therefore, we plan to step up our activities in this area. This week we are also sending letters to about 150 additional schools not yet contacted by Federal officials, asking that they provide us with certain data preparatory to a potential site visit by my staff. This letter is similar to an earlier letter sent by me and the Assistant Secretary for Management and Budget, Kevin Moley to the top 120 research institutions in the country. We also plan to follow up on this earlier letter to determine what action, if any, has been taken by these schools.

With respect to our continuing review of indirect costs, we also plan to continue an agreement we have had with the Department's Division of Cost Allocation (DCA) to work jointly with them in reviewing selected aspects of about 20 schools' indirect cost proposals each year. These efforts have proven very successful in the past and have resulted in significant reductions in charges to indirect costs.

I would also point out that the Department as a whole is moving to address the serious issues surrounding research funding. Toward this end, the Secretary has created a Task Force comprised of the Director of the National Institutes of Health, the Assistant Secretary for Management and Budget and the Inspector General who have been asked to study the rising costs of research with specific emphasis on indirect costs. Over the past several weeks staff of these offices have been developing recommendations to OMB for short range improvements to A-21. The working group plans to also continue to meet to develop long-range solutions to problems related to reimbursement policy contained in A-21.

Other OIG Strategies

As noted earlier, we have developed a long-range strategy for dealing with research activities at colleges and universities. This strategy is based upon our experiences and audit work over the years and is designed to address systemic internal control problems. In our strategy paper, which has been submitted for the record, we define over 40 audit areas of ongoing or planned work. Thirteen areas will address cost containment issues--as an example, we plan to identify existing governmentwide cost containment initiatives which have been effective and determine if they might be applied to colleges and universities; and we plan to review how the NIH can better monitor research costs. Ten audit areas will address indirect cost reimbursement issues, and 17 projects will address the Federal system for funding research and the adequacy of Federal oversight. We also plan to identify alternative approaches to monitoring research efforts.

In addition to our current review of indirect cost issues, we have scheduled 15 projects from our long range strategy for immediate attention. Several of these projects have already begun, and we expect to complete this phase of our strategy over the next 24 months.

Future Options

Our audit findings and experience over the years lead us to believe that there must be better ways for the Federal Government to deal with reimbursement for research efforts on grants and contracts at colleges and universities. There are many options for better ensuring that the dollars available produce the maximum support for scientific research. We have identified a number of options that might be considered for further study, including:

- Indirect Cost Rates

  Significantly amend, as OMB proposes, or modify Circular A-21 to ensure that certain specific costs are excluded from indirect cost reimbursements paid to colleges and universities receiving Federal research grants.

- Block Grant

  Block grant research dollars to universities. Under this option, institutions would be given a set amount of money to meet the joint government institution research goals. The institution would determine how much would go for direct and indirect costs.

- Principal Investigators

  Award research dollars to principal investigators. The investigator would then be responsible for including in their proposals the indirect cost component at the school where the research will take place. The investigator and the school would be forced to negotiate direct and indirect costs.

- Standardized Accounting Systems

  Mandate a standardized accounting system for the major colleges and universities hosting Federal research grants that would reduce variations among schools as to how they account for and allocate costs.

- Cap

  Place a cap on the indirect cost rate. For example, limit the indirect cost rate to the mean or average rate. Under this option, the savings from capping indirect costs could increase the number of grants and funding levels for science.

- Limit Rates

  Limit future indirect cost rates at a level which does not exceed the school's 1991 negotiated rate.

- Lowest Level Charged

  Limit the indirect cost rate for Government research grants to the lowest level charged by the institution to other U.S. and foreign entities. The OIG has observed differential treatment for research funded by the Government vs. Research performed on behalf of U.S. and foreign corporations and foundations.

  Both public and private schools charge a lower indirect cost rate to foundations, public corporations and foreign Governments for research projects than they do to the U.S. Government for federally funded research. Some schools waive the indirect cost rate, even for a million dollar contract with a publically traded corporation. Schools with a Federal indirect cost rate as high as 77 percent waive or reduce the rate with other entities to as little as 6 or 10 percent. Others have a sliding scale, for the indirect cost rate, using whatever rate can be negotiated. It appears clear from this anecdotal information that schools may be looking to the Federal Government to cover the overhead associated with research performed for nonfederal and foreign entities.

- Cost Sharing

Mandate "cost sharing" for research, i.e., the school would contribute a percentage of the total cost of research. This notion of cost sharing was previously in place but was found to be inequitable among schools. The practice was discontinued in 1986. With additional thought and work, cost sharing might be feasible. It was not equitable among all schools, so the practice was discontinued. With additional thought and work, cost sharing might be feasible.

- Add-on Costs

Limit indirect costs to only those expenditures that are add-on costs to the institutions for supporting research. Those university costs that would be incurred whether or not the research was being conducted would thereby not be eligible for indirect cost support.

- Fundings for Oversight

Increase funding levels for Federal oversight efforts (audit and cost allocation work at educational and nonprofit institutions.

- Agency Specific Negotiations

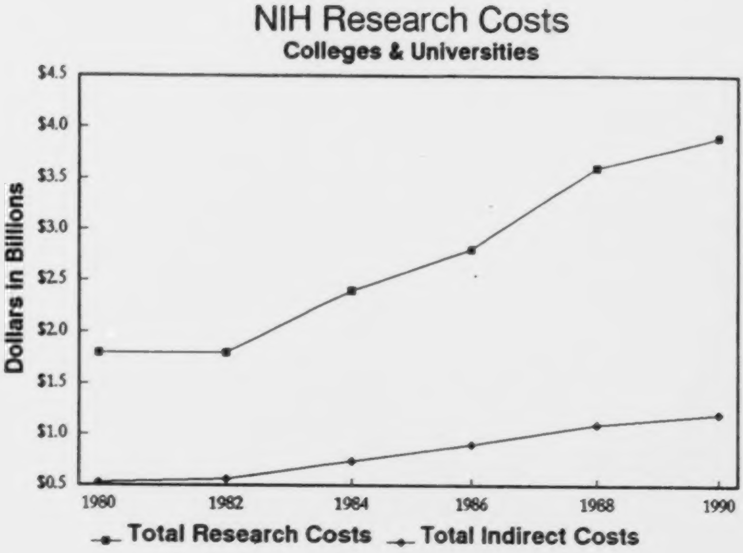
  Do away with governmentwide rules, and allow granting agencies to negotiate the rates for their agencies' grant programs separately. Currently, at NIH, for example, scientists submit proposals for new grants to scientists. However, the indirect cost rates are negotiated without either scientific party. It takes place between the accountants at the university finance office and the accountants for the Department. The proposed option would mean an agency could negotiate a rate for all their grants by discipline. In this way, biomedical research and social research costs could have different rates.

- Recovery

  Seek legal authority for the actual recovery of inappropriate expenditures charged to indirect cost pools and for their return for programming for future funding of science. Currently, when auditors note findings which are sustained, there is no check that is tendered back to the program for future use in scientific research. The general practice is to offset the amount against future indirect cost rates. In some cases there may be adjustments between the direct and indirect cost pools. The net effect is that the money seldom leaves the campus. On some fairly rare occasions, there have been checks written to pay back the money. However, the funds do not go to be reprogrammed for new research, but to the general fund of the treasury. The system does not lead to much in the way of accountability or incentives for efficient use of those funds.

This concludes my testimony. I will be happy to answer any questions you may have.

APPENDIX A


NIH Research Costs
Colleges & Universities
Dollars in Billions
$4.5
$4.0
$3.5
$3.0
$2.5
$2.0
$1.5
$1.0
$0.5
1980
1982
1984
1986
1988
1990
Total Research Costs
Total Indirect Costs

Appendix B

OMB CIRCULARS

A-21	COST PRINCIPLES FOR EDUCATIONAL INSTITUTIONS Provides to colleges and universities, as well as Federal Agencies, the principles for determining the costs applicable to research and other work performed under federally sponsored agreements.
A-88	INDIRECT COST RATES, AUDIT AND AUDIT FOLLOW-UP AT EDUCATIONAL INSTITUTIONS Establishes indirect cost rates, auditing, correcting systems deficiencies and resolving questioned costs.
A-110	UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND OTHER AGREEMENTS WITH INSTITUTIONS OF HIGHER EDUCATION, HOSPITALS AND OTHER NON PROFIT ORGANIZATIONS Provides guidance to grantees and contractors for financial management of federal funds received.
A-128	AUDITS OF STATE AND LOCAL GOVERNMENTS Establishes audit requirements for State and local governments receiving federal aid and defines federal responsibilities for implementing and monitoring those requirements.
A-133	AUDITS OF INSTITUTIONS OF HIGHER EDUCATION AND OTHER NON PROFIT INSTITUTIONS Establishes audit requirements and defines federal responsibilities for colleges and universities. Requires schools have audit of federal awards every two years.

DIRECT AND INDIRECT RESEARCH COSTS - TOP 20 COLLEGES AND UNIVERSITIES BY COGNIZANCE
(DOLLARS IN THOUSANDS)

INSTITUTION	COGNIZANCE	TOTAL R&D AWARDS*	ESTIMATED INDIRECT COSTS	DIRECT COSTS	INDIRECT COST RATE AS A PROPORTION OF DIRECT COSTS
STANFORD UNIV.	DOD	$239,847	$100,401	$139,446	72.00%
JOHNS HOPKINS UNIV.	HHS	211,879	83,467	128,412	65.00%
MASS. INST. OF TECHNOLOGY	DOD	207,157	75,629	131,528	57.50%
UNIV. OF WASHINGTON	HHS	203,691	70,560	133,131	53.00%
UNIV. OF CALIF. @ LOS ANGELES	HHS	170,839	55,407	115,432	48.00%
UNIV. OF MICHIGAN	HHS	167,865	62,290	105,575	59.00%
UNIV. OF CALIF. @ SAN DIEGO	HHS	166,601	54,788	111,813	49.00%
UNIV. OF CALIF. @ SAN FRANCISCO	HHS	159,027	44,206	114,821	38.50%
UNIV. OF WISCONSIN @ MADISON	HHS	150,474	45,978	104,496	44.00%
COLUMBIA UNIVERSITY	DOD	150,263	63,955	86,308	74.10%
YALE UNIVERSITY	HHS	146,245	59,194	87,051	68.00%
HARVARD UINVERSITY	HHS	141,760	58,616	83,144	70.50%
CORNELL UNIVERSITY	DOD	139,954	52,663	87,291	60.33%
UNIV. OF PENNSYLVANIA	HHS	132,805	52,317	80,488	65.00%
UNIV. OF CALIF. @ BERKELEY	HHS	131,070	43,104	87,966	49.00%
UNIV. OF MINNESOTA	HHS	128,727	39,333	89,394	44.00%
PENNSYLVANIA STATE UNIV.	DOD	119,435	39,652	79,783	49.70%
UNIV. OF SOUTHERN CALIFORNIA	HHS	114,766	43,261	71,505	60.50%
DUKE UNIVERSITY	HHS	108,611	36,204	72,407	50.00%
WASHINGTON UNIV.	HHS	102,974	39,410	63,564	62.00%
TOTAL/AVERAGE		$3,093,990	$1,120,435	$1,973,555	56.77%

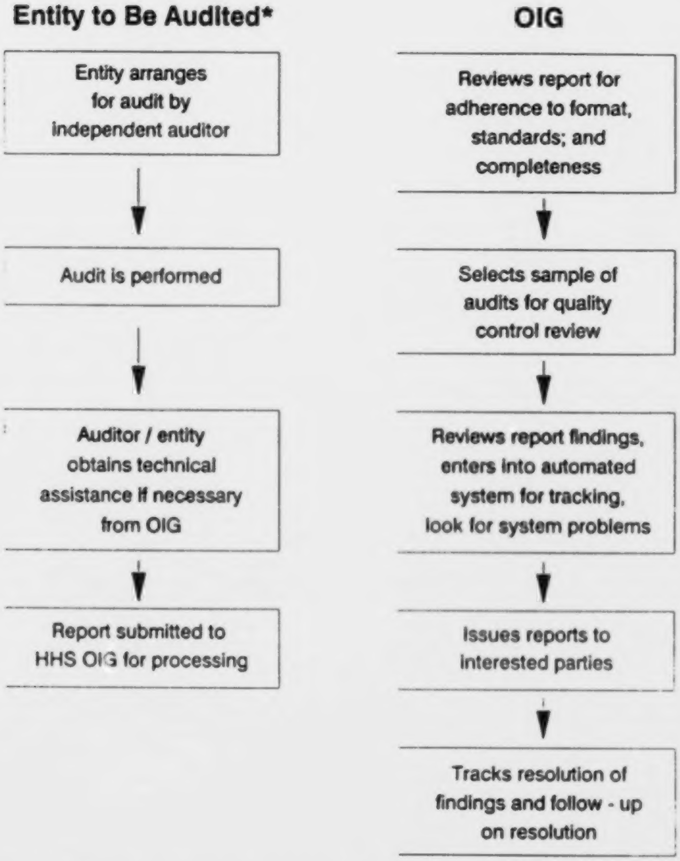
* FY 1989

Weighted Average Indirect Cost Rates In Major Colleges and Universities By Cost Center and Total
1982 - 1991

	82	83	84	85	86	87	88	89	90	91
General and Administrative	7.34%	7.12%	7.33%	7.40%	7.23%	7.15%	7.29%	7.27%	7.32%	7.30%
Departmental Administration	14.04%	15.33%	15.63%	15.47%	15.87%	15.55%	15.75%	16.06%	16.07%	16.09%
Sponsored Projects Administration	3.26%	3.11%	2.98%	3.18%	3.29%	3.33%	3.11%	3.14%	3.26%	3.27%
Student Services	0.53%	0.19%	0.11%	0.15%	0.17%	0.16%	0.14%	0.16%	0.15%	0.17%
Library	2.05%	1.99%	1.97%	2.14%	2.17%	1.98%	2.05%	2.05%	2.03%	2.04%
Depreciation / Use allowances	4.17%	4.36%	4.57%	$4.71%	5.04%	5.22%	5.44%	5.82%	6.27%	6.46%
Operation & Maintenance	11.95%	12.59%	13.26%	14.05%	14.38%	14.76%	14.95	15.01%	15.47%	15.68%
Other / Misc	0.96%	1.18%	1.24%	0.71%	0.60%	0.65%	0.22%	0.02%	0.00%	-0.02%
Weighted Average Negotiated Rate	44.30%	45.88%	47.09%	$47.84%	48.77%	48.80%	48.95%	49.53%	50.57%	50.99%

Appendix E

Responsibilities of Entities and the OIG Under Circular A - 133


Entity to Be Audited*
OIG
Entity arranges for audit by independent auditor
Audit is performed
Auditor / entity obtains technical assistance if necessary from OIG
Report submitted to HHS OIG for processing
Reviews report for adherence to format, standards; and completeness
Selects sample of audits for quality control review
Reviews report findings, enters into automated system for tracking, look for system problems
Issues reports to interested parties
Tracks resolution of findings and follow - up on resolution

*Audits are to be performed at least once every two years at colleges, universities or nonprofit organizations receiving $100,000 or more.

Appendix F

EXAMPLES OF UNALLOWABLE OR INAPPROPRIATE INDIRECT COSTS CONTAINED IN COST POOLS

- President's and Trustee travel includes wife
- Travel expenses for Trustees who donated their travel and did not receive reimbursement
- Trustee banquet charges for such purposes as alumni clubs, commencement and student breakfasts
- Chauffeuring for the President and Trustees. Some chauffeuring for President's wife
- President's official entertainment to financially support his responsibilities as president
- Legal expenses relating to:
    - suit regarding violation of student's civil rights
    - U.S. Justice Department anti-trust suit
    - private suit regarding price fixing of tuition
- Sculpture that had already been paid for by a school contributor
- Depreciation for equipment no longer in use
- Depreciation for athletic equipment
- The cost of producing a community report to promote university activities
- Advertising to promote student attendance at summer session and on career week
- Fund raising
- Student activities such as, fraternity task force, bands for student dance, van rentals for student luggage, furniture for student clubs
- Mailings and other expenses related to alumni activities
- President's house, includes receptions, flowers, travel to sporting events and gifts, e.g. crystal decanters from Neiman Marcus
- Expenses related to an art museum

Mr. **Dingell**. Mr. Kusserow, the committee thanks you for your very helpful testimony, and I want to commend you for what you and your associates have done in terms of bringing to light matters which are of concern to this committee.

We also, as you will recall, had the privilege of working with you in connection with the generic drug investigation, where you served the public interest, I think, in a very spectacular fashion, and I'd like to note that here for the record since I've not had a previous opportunity to tell you personally how much we appreciate the work you did and how much we respect you and your office for the quality of the work which you did.

The Chair is going to recognize my colleagues for questions. The Chair will begin by recognizing first the distinguished gentleman from Georgia, Dr. Rowland.

Mr. **Rowland**. Thank you very much, Mr. Chairman.

Mr. Kusserow, in your testimony, you point out that of the 13 schools that are presently being audited, 12 had volunteered to make adjustments and the 13th appears to be on the way. Is that correct?

Mr. **Kusserow**. Many of those schools have voluntarily requested that there be adjustments to their indirect cost pools to reflect what they had in terms of inappropriate items. But everything that is reflected on page 14, they have not conceded to.

This is an early return of what our findings have been, but what we're finding also is out of that total of roughly $14 million, $9.5 million were involved with the schools coming forth on their own to correct their indirect cost pools pursuant to their own internal audits. So a very substantial sum of that number is the school.

Mr. **Rowland**. Well, has HHS received any money back at this point?

Mr. **Kusserow**. We have begun to receive money back from individual schools. However, we're just getting involved in the process, and we won't have a total tally until the end. Generally speaking, we would want to complete the process to make sure that we're not selling short.

Mr. **Rowland**. Have you seen any of the money?

Mr. **Kusserow**. Very little thus far. We have, from one of the institutions that's not even reflected on here, we have received checks, but by and large, the money has not come back.

Generally, as I mentioned, that money in all likelihood will not be a check coming back to the Federal Government, but would be rolling forward in the indirect cost rates to offset for the future, which, as I mentioned in my testimony, is a little bothersome.

Mr. **Rowland**. Yes. Well, should we conclude, then, that these fine institutions out there are literally waiting for the Government to knock on their door before they will take the necessary corrective action? It's a little bothersome also to me that they're going to wait and take a credit for this and move it to future indirect costs.

Mr. **Kusserow**. It's amazing how, when you do knock on the door, they're ready to announce that they have already done the work, and there's no need to have the auditors look any further, and here it is, and why don't we settle down at that point?

The fact of the matter is that we feel an obligation to—not that we'd question their integrity, but perhaps we would question their bookkeeping—to look a little further into the process. Indeed, there is a lot more money that we're finding out there than what they are voluntarily offering up.

Again, I would go back to the disturbing element, and again maybe it's because I come from an audit perspective, and that is the notion that they don't write a check back, that somehow that money stays on campus and is just rolled forward. Although it means that their rates for the future will be less and will be offsetting what they had inappropriately, the fact is that maybe if they had to write a check for the entire amount that was inappropriately spent, with interest, that might discourage them.

The other point that I would emphasize is that the vast majority of these schools that we're looking at are schools that had a proposal that they would want to put things into the pool, and what you're finding here is we're saying, "No, these are inappropriate for putting in the pool," so they have not actually spent that money yet. We're preventing them from spending the money.

One of the things that I would want to emphasize also is that is the basic philosophy of our Department and our stewardship with the universities, is to try to get it on the front-end side, and not wait until they do spend a lot of money inappropriately, and then come in after the fact and ask them for the money. We'd much prefer to take it out of the pool before they start spending the money and charging us.

Mr. ROWLAND. Well, it sounds kind of like a game. Let me ask you this question.

Mr. KUSSEROW. Yes, sir.

Mr. ROWLAND. Your office is releasing a report on Federal funding to colleges and universities, and in that introduction, and I quote, "Through our audits, we found and reported many serious problems, including miscalculations, mischaracterizations, and misrepresentations of cost. Most of these reflect the result of gaming the intricate rules that pertain to the allowability of expenses for Federal reimbursement."

Now, let me ask you, do you personally believe, as your report states here, that these institutions are, in fact, gaming the Federal Government?

Mr. KUSSEROW. Yes, sir. Thank you for bringing that up because I did bring this report to release to the committee today, and I'd like to have it, with the permission of the Chair, to submit it for the record. It's the report on Federal funding to colleges and universities in support of research, which we pushed ahead for this committee.

Mr. DINGELL. Would the gentleman yield for just a second?

Mr. ROWLAND. Yes, I'll yield to the chairman.

Mr. DINGELL. And the Chair thanks the gentleman. Would you submit that for the record, please?

Mr. KUSSEROW. Yes, sir, I sure will.

Mr. DINGELL. Without objection, that will be inserted in the record.

[Testimony resumes on p. 361.]

[The report follows:]

DEPARTMENT OF HEALTH & HUMAN SERVICES
Office of Inspector General

Memorandum

Date MAY 8 1991

From Richard P. Kusserow
Inspector General

Subject OIG Report "Federal Funding to Colleges and Universities in Support of Research" CIN: A-15-9-00033

To Kevin E. Moley
Assistant Secretary for Management and Budget

Bernadine P. Healy, M.D.
Director, National Institutes of Health

Attached for your use is an Office of Inspector General (OIG) report entitled "Federal Funding to Colleges and Universities in Support of Research." It is part of our contribution to the Department of Health and Human Services' (HHS) work on the cost of research.

The report includes a summary of over 2,000 OIG audits conducted between October 1, 1988 and March 1, 1991. It also describes OIG strategies for addressing issue areas associated with HHS funding for biomedical research and some options for ensuring that limited funds are equitably apportioned for the direct and indirect costs of research conducted by colleges and universities.

The OIG is currently conducting audits of indirect costs at a number of colleges and universities across the country. We will share early findings from these audits with work group members as they develop. Also, we will provide you an opportunity to comment on all audit reports related to these schools.

We anticipate that this document will provide some insights to and generate more questions on the complexities of funding auditing research grants to colleges and universities.

Please contact me if you have any questions or your staff may contact Daniel Blades, Assistant Inspector General for PHS Audits, Office of Audit Services, at 301-443-3583.

Attachment

Federal Funding
In Support of Research
to Colleges and Universities

Executive Summary

Federal funding for science at colleges and universities has reached $9.2 billion per year, of which about $2.5 billion is for indirect costs. The remaining $6.7 billion is for direct research costs. Audit and cost negotiation responsibility or cognizance is assigned generally to the Department with the most money. Of the 276 colleges and universities receiving 96 percent of Federal funds, thirty nine are under the cognizance of the Department of Defense and the balance of 237 are assigned to the Department of Health and Human Services.

Over the years, serious questions have been raised about the amount of Federal funding being diverted to indirect costs (unallocated overhead to the hosting school) and away from direct research costs (arising from the scientific projects). These issues have been underscored by recently identified questionable charges to indirect cost pools by certain schools.

The experience of hundreds of audits have identified many options for better assuring appropriate division of Federal funds between unallocated overhead (indirect costs) and direct research costs, including but not limited to the following, variations of the following, or combinations thereof:

- o Revising OMB Circular A-21, Cost Principles for Educational Institutions which provide guidance for determining the costs applicable to direct research or indirect costs at the host institutions.
- o Issuing block grant research dollars to universities. Under this option, institutions would be given a set amount of money to meet the joint governmental institution research goals. The institution would determine how much would go for direct and indirect costs.
- o Awarding research dollars to principal investigators. The investigators would then be responsible for including in their proposals the indirect cost component at the school where the research will take place. The investigators and the schools would be forced to negotiate direct and indirect costs.
- o Mandating a standardized accounting system for the major colleges and universities hosting federal research grants that would reduce variation among schools as to how they account for and allocate costs.
- o Capping the indirect cost rate. For example, cap indirect cost rates at the mean or average rate. This would result in savings that could increase the number of grants and funding levels for science.

- Limiting future indirect cost rates at a level that does not exceed the 1991 negotiated rate.

- Limiting the indirect cost rate for government research grants to the lowest level charged by the institution to other U.S. and foreign entities. The OIG has observed evidence of differential treatment for research funded by the government vs. research performed on behalf of U.S. and foreign corporations and foundations.

- Mandating "cost sharing" for research, i.e., the school would contribute a percentage of the total cost of research. This notion of cost sharing was in place back in the mid-eighties. It was not equitable among all schools, so the practice was discontinued. With additional thought and work, cost sharing might be feasible.

- Limiting indirect costs to only these expenditures that are add-on costs to the institutions for supporting research. Those costs to the university that would be incurred whether or not the research was being conducted would thereby not be eligible for indirect cost support.

- Increasing funding levels for Federal oversight efforts (audit and cost allocation work) at educational and nonprofit institutions.

- Eliminating governmentwide rules, and allowing granting agencies to negotiate the rates for their agencies' grant programs separately. Currently, at NIH, for example, scientists submit proposals for new grants to scientists. However, the indirect cost rates are negotiated without either scientific party. It takes place between the accountants at the university finance office and the accountants for the department. The proposed option would mean an agency could negotiate a rate for all their grants by discipline. In this way, biomedical research and social research costs could have different rates.

- Seeking legal authority for the actual recovery of inappropriate expenditures charged to indirect cost pools to be returned for programming for future funding of science. Currently, when auditors note findings which are sustained, there is no check that is tendered back to the program for future use in scientific research. The general practice is to offset the amount against future indirect cost rates. In some cases there may be adjustments between the direct and indirect cost pools. The net effect is that the money seldom leaves the campus. On some fairly rare occasions, there have been checks written to pay back the money. However, the funds do not go to be reprogrammed for new research, but to the general fund of the U.S. Treasury. The system does not lead to much in the way of accountability or incentives for efficient use of those funds.

INTRODUCTION

The Federal government devotes vast sums of money to supporting research at colleges and universities. At HHS, we try our best to stay on top of it. In the last decade, there have been thousands of cost negotiations and audits. We have performed or reviewed more than 2000 audits during the last three years. A disproportionate share, 5 percent, of our audit resources have been committed to this activity, which, while large, represents only 1 percent of the Department's budget.

Through our audits, we found and reported many serious problems including miscalculation, mischaracterization, and misrepresentation of costs. Most of these reflect the results of "gaming" the intricate rules that pertain to the allowability of expenses for Federal reimbursement.

The reimbursement system itself breeds such gaming because of its complexity. There are direct costs, indirect costs, allowable costs, allocable costs, reasonable costs, recharge centers, special projects and others. The relationship among these is extraordinarily complex. At times, even accountants, lawyers, and business officers cannot agree on the difference between direct and indirect costs. Different universities handle them in different ways.

We believe it is futile to try to solve this problem solely through accounting and more audits. Fundamental reform is necessary. We need to change the way we do business. We suggest a number of basic reforms for consideration.

The Department as a whole is moving to address the serious issues surrounding research funding. Toward this end, a working group was formed comprised of the Director, National Institutes of Health, the Assistant Secretary for Management and Budget and the Inspector General to study rising costs at colleges and universities. We believe that our experiences in the Office of Inspector General (OIG) can provide insights to the team as it sorts out the tensions and incentives underpinning both the government's and schools' efforts to advance our nation's health through biomedical research.

To assist the HHS team in their analysis, we will illustrate the complexity of this problem by: describing the complicated Federal guidance that governs the relationship between agencies and grantees and the OIG experience in working with that guidance; summarizing the findings of over 2000 OIG audits conducted between October 1, 1988 and March 1, 1991; describing OIG strategies for addressing issue areas associated with HHS funding for biomedical research; and describing some options for ensuring that limited funds are equitably apportioned for the direct and indirect costs of research conducted by colleges and universities.

CHAPTER I

FEDERAL GUIDANCE AND OIG EXPERIENCE

Recently, it has come to light that various colleges and universities have included unallowable or inappropriate expenses in their charges to the Federal Government for overhead or indirect costs. However, the Government's effectiveness in overseeing Federal grants to colleges and universities is not a new issue.

Federal Funding

Colleges and universities are increasingly dependent on the Federal Government for funding to conduct research, particularly biomedical research. Since 1984, total Federal research and development obligations to colleges and universities have increased from $5.6 billion to the current level of over $9.2 billion. This represents an increase in funding of 64 percent. Indirect costs provided to colleges and universities over the same period have increased from $1.5 billion in 1984 to $2.5 billion.

A majority of the research grant money comes from the Public Health Service (PHS) of the Department of Health and Human Services (HHS). The National Institutes of Health (NIH) funding alone accounted for $3.9 billion in Fiscal Year 1990, of which $1.25 billion was for indirect costs.[1] For FY 1991, NIH has provided for $3.7 billion for extramural research, of which $1.7 billion will pay for indirect costs.

There is good reason to believe that the trend for direct and indirect costs for research will continue for the foreseeable future. Fiscal constraints and increasing competition for budget dollars are resulting in pressure to increase the amount of money applied to direct research rather than to indirect or unallocated overhead costs. It is interesting to note that the indirect costs for research funded in Fiscal Year 1990 by NIH exceeded the amount spent on AIDS research. Similarly, the amount anticipated for indirect costs for all NIH extramural grants in 1991 will exceed the total budgeted for cancer research.

OMB Guidance

There is a perception that the relationship between the Federal government and the university world is a very loose one. Nothing could be further from the truth. Federal guidance from both OMB and the individual funding agencies is voluminous, complex, and detailed. Government-wide instructions issued by OMB address virtually all aspects of Federal funding of university and nonprofit institutions. This guidance--issued in the form of OMB Circulars[2]--is binding on all parties.

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[1] Appendix A depicts the growth in NIH research costs from 1980-1990, showing growth in both direct and indirect costs.

[2] Appendix B provides a summary of applicable OMB Circulars.

There are three general aspects of Federal guidance which are necessary to understand the current situation. These are Cognizance (assignment of oversight responsibility to agencies), Indirect Costs, and Audit Requirements. Each is addressed individually below.

Cognizance

OMB Circular A-88 generally assigns cognizance responsibility for colleges and universities, to the Federal agency with the largest sum of money represented at the school. Over 90 percent of the colleges, universities, and nonprofit organizations receive most of their Federal funding from HHS and, therefore, fall within our cognizant responsibility. The other major cognizant agency is the Department of Defense (DOD), which is assigned cognizance for 39 major schools.[3] Audits are performed directly by the cognizant agency (at HHS, the Office of Audit) and by private sector auditors. Non-Federal auditors review financial and compliance issues at colleges, universities and nonprofit organizations in accordance with OMB guidance. The auditors are required to include within their scope of work, the indirect cost pools charged to the Federal Government. Federal auditors in the cognizant agency review their work to assure that it has been performed according to audit standards and to identify issues warranting follow-up.

Indirect Costs

The total cost of any research project is divided into direct and indirect costs. Direct costs are those that can be identified specifically with a particular sponsored project, instructional activity or any other institutional activity; or that can be assigned directly to such activities with a high degree of precision. Examples of direct costs include salaries and wages of those working on the projects, laboratory supplies, equipment, subcontracts and any other direct overhead expenditure. Modified Total Direct Costs (MTDC) is an important subcategory of direct costs. It usually includes all direct costs except equipment and that portion of subcontract costs in excess of $25,000. Modified direct costs are significant because they are the basis used to determine the extent to which indirect costs are assigned to individual Federal grants and contracts.

Indirect costs include those costs that have been incurred for common or joint objectives of the university including the research effort housed at their facilities. They cannot always be identified readily and specifically with a particular sponsored project, or institutional activity.

OMB guidance (A-21) provides to colleges and universities, as well as Federal agencies, the principles for determining the costs applicable to research and other work performed under federally sponsored agreements. The principles do not attempt to identify the extent of agency and institutional participation in financing the costs of a particular project. Rather, they were designed so that the Federal Government would bear only its fair share of total costs, determined in accordance with generally accepted accounting principles, except where restricted or prohibited by law.

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[3] Appendix C reflects the distribution of responsibility between HHS and DOD for the 20 schools which receive the most research dollars.

The principles in A-21 for Federal grants were established over 30 years ago when the research environment and Federal funding were less complex. They have been modified only 8 times over the years, and, in our opinion, A-21 has not kept pace with changes in the scientific research arena and with today's business and accounting practices. By contrast, the Federal Acquisition Regulations (FAR), relating to contracts, are modified almost monthly to keep up with problems and changing business practices.

In 1985, the issue of indirect costs for research again arose. The OIG was asked to study the reasons for the dramatic increases in indirect costs for research funded by the department. We looked also at the legitimacy of indirect costs. In response to our report, the HHS Assistant Secretary for Management and Budget, OIG, the Office of Science and Technology Policy and OMB recommended changes to the principles (A-21). The OIG recommended that: (1) the amount of departmental administration expenses chargeable to sponsored research be established at a fixed allowance of 7 percent of the direct cost of research; and (2) the use of multi-year predetermined indirect cost rates be expanded. Now, in 1991, the OIG again is working closely with other Departmental officials, OMB, and the Congress to review the effectiveness of Federal controls over research costs.

In 1988, in response to the growing concern over indirect cost issues, the Executive Committee of the Association of American Universities (AAU) charged an ad hoc committee, to review the current system, particularly OMB guidance (A-21) and to identify suggestions for change. According to the Committees's draft report, the entire context in which the indirect cost system operates is changing. Important changes include pressures on university faculty, cumulative effects of conflicts between research faculty and university officers over indirect costs, increasing obsolescence of research facilities and equipment, and the basic relationship between universities and the Federal Government's support of research.

The HHS process and experience with indirect cost is important. The weighted average indirect cost rate for major research universities negotiated by HHS has remained fairly stable at 48 percent in 1985 to about 51 percent in 1991.[4]

Many schools over this period have requested significant increases in their indirect cost rates. The Division of Cost Allocation within HHS reviews and negotiates indirect cost rates proposed by the institution. The negotiation process is important to ensure that the maximum number of Federal dollars are used for research expenses and activities. Our audit staff may be called upon to support this work.

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[4] Appendix D shows the weighted average indirect costs from 1982 to 1991. It also shows that portion of the overall rate attributable to the various cost centers that make up indirect costs.

The Department's effort has greatly limited the rise in indirect costs at HHS cognizant schools. To place this effort in perspective, the average indirect cost rate proposed by the schools for HHS cognizant colleges and universities is 58.57 percent. The negotiated rate for these same schools is 50.99 percent, a difference of 7.58 Percent. This difference yields estimated annual savings of $200 - $300 million.

The following table illustrates the impact of negotiations on establishing indirect cost rates. The table includes a geographic spread of "high dollar" schools and a summary of all schools negotiated.

Institution	Percent indirect proposed	Percent cost rate negotiated	Percent 1990 decrease	1991 proposed indirect rate*
Howard University	155	75	80	122
Harvard				
Medical School	98	77	21	104**
University	78	68	10	86
Johns Hopkins University	74	64	10	74
UCLA	48	46	02	63
University of Washington	70	51	19	66
Washington University	62	60	02	64
Overall 1990	59	51	08	59

* final rates have not yet been negotiated, as of April 1991.

** Harvard's original proposal was for 104 percent. They subsequently made adjustments which resulted in a proposal of 94 percent.

The approximate savings that result from a single percentage point reduction of the mean indirect cost rate nationwide is $43 million. This amount is based on calculations using figures from 119 major institutions including 19 institutions negotiated by the DOD and includes a number of assumptions. The indirect cost associated with the 119 major institutions includes 90 to 95 percent of all indirect cost paid to educational institutions.

The savings that result from indirect cost rate changes at individual institutions vary widely depending on a number of factors, such as, the indirect cost rate, the amount of Federal research paid to the institution and the amount of indirect costs claimed. Based on national averages, the savings per point at individual institutions amounts to about $46,000.

In our opinion, the current version of OMB guidance (A-21) does not provide incentives to schools to minimize or contain costs allocated to Federal research projects. Basically, A-21 permits universities to charge expenses to Federal research when those expenses are allowable, allocable, and reasonable. Costs are considered reasonable "if the nature of the goods or services acquired or applied, and the amount involved therefore, reflect the action that a prudent person would have taken under the circumstances prevailing at the time the decision to incur the cost was made." This subjectire test of reasonableness provides great latitude for schools to include many items and services which might otherwise be excluded under the more specific Federal acquisition regulations. A cost is allocable to a specific project if "the goods or services are chargeable or assignable to such cost objectives in accordance with relative benefits received or other equitable relationship." Again, the non-specificity of A-21 provides discretion and, indeed, incentives to schools to define "benefits received" to their best advantage.

Both OIG and non-Federal auditors, when engaged in reviews of grants and contracts at colleges and universities, must rely on A-21 for Federal policy regarding the allocability, allowability, and reasonableness of charges. Clarification of this policy would enhance the auditors' effectiveness in their oversight role.

Audit Requirements

In 1979, the House Committee on Government Operations and the Government Accounting Office (GAO) released a report criticizing the auditing of Federal grants to colleges and universities calling it haphazard and ineffective. At that time, colleges and universities were responsible for doing school-wide audits of Federal funds (A-110). (A-102P applied the same requirements for State and local governments.) Each Federal agency usually audited only its own grants, without coordinating with other agencies providing funds to the same school. To correct this inefficient approach to audits at colleges and universities and redirect scarce HHS audit resources to the Medicare, Medicaid and social security programs, the OIG supported OMB in the development of a single audit policy. The OIG demonstrated the value of the single audit concept by conducting 30 pilot audits over 3 years. The major outcome of the pilot projects was the development of guidelines for single audits in colleges and universities. The Federal inter-agency task force, chaired by OMB, endorsed use of the guidelines.

In April 1984, the Inspector General testified before the Committee on Government Operations that colleges and universities were reluctant to accept the single audit guidelines. Thus, the IG recommended that legislation be enacted to require this practice. Specifically, we recommended that the Single Audit Act be amended to cover colleges and universities, as well as State and local governments. This proposal was not enacted. However, these principles are now included revised OMB guidance (A-133).

Until January 1990, OMB guidance (A-110, Attachment F) contained provisions for organization-wide audits at colleges and universities. However, the Circular was proven to be inadequate because the audit requirements lacked sufficient detail and did not require that such audits be done in accordance with generally accepted government auditing standards. Further, it did not require the schools to submit the results of their audits to the Federal Government for review.

In response to these perceived inadequacies, OMB issued revised guidance (A-133) for the audits of institutions of higher education and other nonprofit institutions to strengthen audit requirements. Our office worked closely with OMB to develop A-133.

A-133[5] established audit requirements and defined Federal responsibility for colleges and universities and otherwise addressed previous deficiencies. This new guidance, applicable to audits for fiscal years that begin on or after January 1, 1990 requires that schools have an audit of Federal awards every 2 years. The full implementation of this circular will substantially increase and improve audit coverage at these institutions.

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[5] Appendix E describes the responsibilities of colleges and universities, and the OIG under A-133.

CHAPTER II

AUDIT FINDINGS

SCOPE AND METHODOLOGY

Using data in our audit information system, we identified reports of audits conducted at colleges and universities during fiscal years 1988 through March, 1991. During this period, as shown in the table below 2,052 audits reports were issued by OIG. The audits performed by the OIG directly included 207 preaward contract audits and 269 audits of costs incurred on grants and contracts. The remaining 71 were reports of special studies and reviews of indirect or direct costs. The 1505 non-federal audits included 944 performed under OMB Circular A-110, 148 conducted pursuant under OMB Circular A-128, 359 external audits of single or multiple programs, and 54 miscellaneous reviews.

TABLE I

AUDITS OF COLLEGES AND UNIVERSITIES
PERFORMED IN FISCAL YEARS 1988, 1989 AND 1990/91*

FISCAL YEAR ISSUED	OIG	NON-FEDERAL	TOTALS
1988	194	538	732
1989	174	473	647
1990/91	179	494	673
TOTALS	547	1,505	2,052

* Includes first six months of FY 1991

Fluctuations in the number of audits performed can be attributed to several factors. Universities which previously had an audit under Circular A-110 may have been included in a State-wide audit under OMB Circular A-128 the following year. An A-128 audit can encompass several universities in one review. For example, the State of Washington included 6 four-year universities and 24 community colleges in its 1990 A-128 audit. In addition, universities which previously had audits of individual grants may have chosen to have an audit of the entire organization under the guidance in Circular A-110. Such an A-110 audit would include a review of all major grants and contracts and could result in fewer audit reports without a corresponding reduction in audit coverage.

Also, the number of OIG audit reports is a factor of the number of proposals that the universities submit for changes in the indirect cost rates, as well as, requests from other Federal agencies. We analyzed these reports and reports and grouped the audit findings into 3 broad categories: internal control costs, program specific and other issues and internal review areas.

AUDIT FINDINGS BY CATEGORY

For the 42 month period ending March 31, 1991 2052 audits identified a total of 2670 findings. Over 2000 of these findings were reported in non-federal audits and 162 were reported in OIG audits. The table below shows total findings by category.

TABLE II

FINDINGS BY CATEGORY

Category	OIG	Non-Federal	Total	Percent
Internal Control	20	2,196	2,216	83.0
Cost	129	226	355	13.3
Program Specific and Other	13	86	99	3.7
Totals	162	2,508	2,670	100.0

The majority of findings were in the internal control systems category. Over 2000 of these findings were identified in non-federal audit reports, in accordance with Federal audit guidance.

A. Internal Control Category

As shown in Table II, 83 percent of all reported findings were related to internal controls. An internal control system is an overall plan of organization and methods employed to ensure the reliability of accounting data, safeguard assets, promote efficiency, and ensure compliance with established policies. The types of internal control findings (Table III) included reporting, accounting, cash management and property of procurement. Not filing financial and technical reports in a timely manner is an example of internal control weakness in financial reporting. Internal control findings related to an accounting system usually identify weaknesses in reconciling accounts and posting accounts in a timely manner. Cash management internal control findings generally indicate that an organization was requesting cash from the awarding agency in excess of its needs, while a cash receipts finding indicates inadequate separation of duties regarding receipt, recording and depositing of cash. If an organization did not take inventory of its equipment or did not tag its equipment, the finding would be property related. Generally, each finding includes a recommendation or a series of recommendations to correct a reported weakness, and the auditee is required to report on corrective action taken.

TABLE III

INTERNAL CONTROL FINDINGS
BY TYPE

Type of Finding	OIG Number	NonFederal Number	Total	Percent
Reporting	5	666	671	30
Accounting	3	503	506	23
Cash Need	4	290	294	13
Property Procurement	2	322	324	15
Other	6	415	421	19
Totals	20	2,196	2,216	100.0

1. Internal Controls Over Reporting

Over 600 findings related to financial reporting. These included findings for not filing financial and technical reports in a timely manner.

o Lack of internal controls over effort reporting at a western university resulted in the following:

  -- OIG found that many staff reported 100 percent of their time on departmental administration, when they had actually worked on other activities.

  -- In another instance, at this university's medical school, operating cost of the medical practice plans--faculty members seeing private patients--were not recorded in the allocation base which caused an excessive amount of costs to be allocated to federally sponsored research.

- Salary costs of support staff who worked for the medical practice plan were improperly recorded in the departmental administration cost pool, increasing cost to federally sponsored research.

- The school of medicine inappropriately recorded the cost of medical malpractice insurance in the department administration cost pools. We found that malpractice claims did not result from research projects. Therefore, these costs did not benefit federally sponsored research projects.

- An estimated $7 million of salary costs for 3,000 volunteer faculty members was not reported, resulting in excessive departmental administration costs being charged to federally sponsored research.

- A space utilization study resulted in operation and maintenance costs inappropriately allocated to federally sponsored research.

o At another western school the following were inappropriately reported as indirect cost.

- Presidential events such as receptions for deans and faculty, commencement, pre-football game activities, and other academic events.

- Travel for the band, student affairs, internal work study, and legal fees involving the NCAA.

- Printing of 10-year school history, community relations, and alumni fund raising events.

- Administration of scholarship funds.

- Bad debts and related collection and legal costs.

- Costs related to student loans and endowments.

- Costs related to student catalog, student orientation, and dissertation editing.

- Preparation expenses for the olympics.

- Medical liability malpractice insurance.

o The reporting of cost sharing was an area with weak internal controls. For example, at one university, findings led to a recommendation that internal controls over cost sharing be strengthened by reviewing amounts claimed for grants with specific cost sharing requirements. The review was to determine that the amounts were reasonable, actually expended on the grants, and were not claimed on more than one grant.

2. Internal Controls Over Accounting

There were over 500 findings related to internal controls over accounting, ADP and payroll issues.

- One university's system allowed the charging of costs to be changed without appropriate supporting documentation and adequate management approval.
- At another university, general and subsidiary ledgers were not periodically reconciled for accuracy.
- Another example of an internal control deficiency in an accounting system was demonstrated by a $53,275 payment of principle, interest and trustee fees not being recorded.
- At a midwestern school the OIG found a lack of internal controls over accounting methods resulted in:
  - costs of $106,891 being classified to instruction when they should have been classified to organized research.
  - inclusion of the media resources center, which has nothing to do with the library, in the library cost pool instead of the specialized service center.

3. Internal Controls Over Property/Procurement and Cash Management

The following two examples demonstrate internal control weakness relating to property/procurement and cash management.

- In one university, a weakness in the a department's purchasing function allowed an employee to establish a fictitious company and embezzle over $400,000 from federally sponsored research projects.
- At another university, capital assets were not always properly reported. Improper reporting of capital assets can raise the cost of federally sponsored research.

4. Internal Controls - Other

An "other" internal control weakness is illustrated by our finding related to reportable inventions.

- A recent OIG review looked at controls over inventions, patents, and royalties related to new products discovered by researchers under federal grants and contracts. We found several documented instances where invention disclosures reported inventions developed under federal funding as being developed without federal funding.

B. Cost Category

Table IV describes the major types of findings in the cost category. The greatest number of findings were related to indirect costs (10.9 Percent), fringe benefits (7.9 Percent) and student aid (7.6 Percent). The areas of interest and cost sharing also had a significant number of findings.

TABLE IV

REPORTED COST FINDINGS BY TYPE

Type of Finding	OIG	Non-Federal	Total	Percent
Indirect Costs	26	13	39	10.9
Fringe Benefits	20	8	28	7.9
Student Aid	2	25	27	7.6
Interest	11	15	26	7.3
Cost Sharing	0	23	23	6.5
Equipment & Capital	3	19	22	6.2
Travel	6	16	22	6.2
Payroll Preparation and Other	61	107	168	47.4
Totals	129	226	355	100.0

The following paragraphs discuss those types of cost findings occurring with the most frequency.

1. **Indirect costs** - Indirect costs are expenses that are incurred for common or joint objectives, and therefore cannot be readily and specifically identified with a particular project, an instructional activity or any other institutional activity. The costs of operating and maintaining facilities, equipment, and grounds; depreciation or use allowance; general and departmental administration; and library expenses are typical examples of the types of costs which are usually considered as indirect costs at colleges and universities. Findings regarding indirect costs pertain to unallowable costs, omission of appropriate costs from an indirect cost base or the use of unreasonable allocation methods.

The OIG and the Division of Cost Allocation (DCA) under the Assistant Secretary for Management and Budget (ASMB) pioneered an innovative methodology to review and negotiate indirect cost rates. The OIG auditors and DCA conduct cooperative reviews of indirect cost proposals. The OIG auditors primarily collect data and analyze selected aspects of cost pools and allocation bases. We examined selected issues and made recommendations that substantially strengthened the government's position in negotiations.

Summarized below are typical items the DCA and the OIG find when reviewing an indirect cost proposal.

- Direct Charge Equivalent - One of the vulnerable areas of an indirect cost proposal relates to the classification of certain salary and wage costs as departmental administration rather than a direct cost function. The OIG has often evaluated the classification of selected salaries by interviewing employees and reviewing time cards and other supporting documentation. Frequently, that staff actually work on direct functions such as instruction, student affairs or recharge centers and not departmental administration. Misclassifying the related salaries has the effect of overstating department administration costs allocated to federally sponsored projects.

- Medical Practice Plan (Allocation Base) - Within a medical school, there are revenue producing activities where faculty members see private patients who pay for services received. Although medical practice plans benefit from departmental administration, some universities remove the costs of operating the plans from the allocation base. This effectively understates the indirect cost allocation base and results in an excess amount of departmental administration costs being allocated to federally sponsored research.

- Medical Practice Plan (Pool Costs) - Some universities with medical schools may attempt to include the salary costs of support staff who work for medical practice plans in the departmental administration cost pool. Generally, support staff schedule appointments and bill private patients for services rendered and that from which the federal government receives no benefit. This would necessitate a reduction in the departmental administration cost pool for operating expenses of the medical practice plan.

- Medical Liability Insurance - Universities sometimes include costs which are not related to research, such as premiums for medical malpractice insurance, in the departmental administration cost pools. We found that malpractice claims and litigation arise out of normal hospital activities and not from research projects. Costs for malpractice insurance did not benefit federally sponsored research, except where there were clinical studies involving patients. The OIG recommended that DCA remove the unallowable portion of malpractice insurance from the department cost pools.

- Voluntary Clinical Faculty - Universities which use voluntary faculty do not always make necessary adjustments to include uncompensated staff in an allocation base. It is necessary to make such adjustments so that support costs are allocated to all faculty who benefit. Support costs typically include preparation of course material, tracking of instructional time and preparation of documentation of academic advancement. Since there were no salary costs in the allocation of departmental administration costs was overstated to federally sponsored research. The OIG recommended that DCA increase the base by the estimated cost of $7 million for the voluntary labor.

- Space Utilization - Universities often use special studies to allocate certain indirect costs. However, it is incumbent on the university to update its studies for changes which will affect the allocation of costs. The OIG found that the university used a space utilization study from 1987 to allocate operation and maintenance costs in its 1989 indirect cost proposal. We reviewed the study and identified four departments for which space had been reassigned since 1987, but the space utilization study had not been changed. The OIG reported the overstatement to DCA for use in negotiations.

The results of our work were conveyed to DCA in the form of summary work papers and discussions at pre-negotiation strategy meetings. In addition to performing the field work, we also participated with DCA in direct negotiations with the university.

- Interest Income - At an east coast university, the OIG reviewed interest and costs and reviewed a space utilization study which was used to allocate about 61 percent of federal indirect cost. The OIG found that certain interest income was not used to reduce interest costs and that the space study was not properly supported. As a result of this review, the indirect cost rate was reduced by about 9 percent for Fiscal Year 1990 and about 17 percent for the remaining three fiscal years.

- Administration And Depreciation - At another university, the OIG assisted the DCA by reviewing depreciation expense, sponsored project administration, library expenses and departmental administration. The DCA negotiated an indirect rate lower than that proposed by the university.

- Fringe Benefits - At a university in New York, the OIG auditors reviewed fringe benefit expenses. Based on the adjustments made and negotiations by the DCA, there were substantial savings to the federal government.

During a recent review of cost allocations by a private eastern college to its indirect cost rate, the OIG identified the following examples of unallowable and inappropriate costs:

- President's Travel/Rooms/Meals. This inappropriately included the President's wife who is a member of the faculty. The school withdrew these charges.
- Trustees Travel/Rooms/Meals including expenses for wives of trustees. OIG also noted that liquor for such purposes as alumni clubs, commencement, and student breakfasts were included. Travel expenses for trustees who donated their travel and did not receive reimbursement was also claimed by the school. The school withdrew total trustee expenses.
- A chauffeur for the President's office as claimed. Also a chauffeur for the trustee's office was claimed. The school withdrew these accounts in total.
- President's official entertainment expense. The school withdrew these expenses.
- Legal expenses for:
  - suit by underground newspaper regarding violation of student's civil rights. The school withdrew this claim.
  - U.S. Justice Department Anti-Trust Suit.
  - Anti-Trust private, suit related to price fixing of tuition. The school withdrew these costs.
  - undergraduate committee on standards relating to academic plagiarism. The school withdrew these charges.
- One time outplacement service because the school laid off, forced early retirement or reduced the effort of employees. These costs include insurance, termination or severance expenses for positions relating to student administration and other institutional, non-research activities (Faculty Club).
- Charges for equipment no longer in service. This involved donated equipment which is no longer in use.
- Charges for use allowance for a temporary building no longer in use.
- Charges for operations and maintenance on miscellaneous property related to other institutional activities. These included a student parking lot and

driveway to boathouse, storage facility for college canoes and kayaks, cabin (used for various college functions and under the responsibility of the athletic department), a house donated by the former President, college grant buildings, a historic cottage, and a building used by fine arts from pottery classes. The school withdrew all these accounts.

- Unallowable legal expenses at an organization affiliated with and easter private school, were included in its indirect cost pool. The school sent a check for the overcharge.

- Depreciation expenses proposed by a mid-western university for buildings and equipment were not computed in accordance with the cost principles set forth in OMB Circular A-21. Specifically, the current depreciable value of assets was determined by deducting cumulative use-allowances taken, rather than accumulated depreciation, from the assets acquisition costs. In addition, depreciation expenses were overstated because (i) the useful life of assets was not based on actual experience and (ii) salvage values were not considered. The actions by one university resulted in overstating the university's proposed indirect cost rate for organized research by 5.33 percentage points. A decrease of 5.33 points is equivalent to about $2 million annually in indirect cost reimbursement under federal grants and contracts.

- OIG found significant deficiencies in the energy study at a mid-western school. We found an inordinate number of exceptions relating to the accuracy of the data collected and determined that the proposed energy costs applicable to research were significantly overstated.

- Cost of Operating an Experimental Farms Charge to the Federal Government. A study at another mid-western school reviewed research indirect cost rates. The primary rates pertain to research awards made to the two main campuses which are identified by the university as the doctoral cluster. Included in the development of these rates was a component known as experimental farms. These "farms" represent a significant enterprise within the school system.

Our review disclosed that the practice resulted in a large portion of the costs of operating the farms being charged to research awards that did not involve the use of the farms. Conversely, only the remaining smaller portion of the cost was being charged to the research awards that involved the use of the farms. In addition, this practice has resulted in the annual farm operating costs being improperly charged to the federal government due to the fact that relatively small portion of the federal awards involved the use of the farms.

- An OIG review disclosed at another mid-western school a significant misallocation of space identified as organized research should have been classified as instruction or some other function and not allocated to federal programs.

2. Fringe Benefits - Fringe Benefits provided by educational institutions are usually in the form of paid vacations, holidays, sick leave, health and life insurance, and contributions to social security and unemployment insurance and pension plans. The costs of these benefits are allowable charges if the benefits are equitable and granted in accordance with policies of the institution, basis. A finding in this area occurs when a university claimed more fringe benefits on federal awards than was actually incurred.

- o We found that one university, we delayed the adoption of financial accounting standards related to employers' accounting for pensions. This means that more retirement expense was recorded during the two years ended August 31, 1989 than would have been permitted had the standard been implemented. As a result, federal research grants were overcharged.

  1) OIG auditors found that one university inappropriately excluded from the labor base, the costs associated with non-university employees. working at an off-site location.

  2) At another university, we found that the school excluded from the pool of fringe benefits' costs associated with university employees working at an off-site location. In addition, we found that the university included in the pool fringe benefits associated with non-university employees.

  3) We questioned $736,975 of employees compensated absences which were included in one university's fringe benefit pool because there was no documentation to support the charge.

3. Student Aid - These findings usually involved the Nursing Student Loan and Health Professions Student Loan programs. These programs are used to provide financial assistance to eligible students. The auditors reported findings that the university maintained excess cash for these programs, failed to credit investment earnings to the programs or disbursed loans while the programs were in suspension.

- o At one university a problem was identified involving the Nursing Student Loan (NSL) and Health Profession Student Loan Programs (HPSL). The school accumulated excess cash under the NSL and HPSL programs. Federal guidelines require that funds in excess of those needed should be reported on the annual operating report issued by the university and returned to the federal government.

- o At another university, loans had not been made for its HPSL program for its HPSL program for the past two years. However, a federal fund balance of $94,770 had been retained.

- Another college's NSL program was placed on suspension by HHS on January 1, 1987 and was returned to active status on January 1, 1989. The college disbursed loans totalling $57,650 while the program was suspended. The college returned $23,068 to HHS for loans disbursed during the suspension period.

4. **Interest** - The interest category pertains to either the cost of borrowing capital or interest income not credited to federal awards or programs. Under Circular A-21, costs incurred for interest on borrowed capital are unallowable except when associated with assets used in support of sponsored agreements for (1) buildings acquired or completed on or after July 1, 1982, (2) major reconstruction and remodeling of existing buildings completed on or after July 1, 1982, and (3) acquisition or fabrication of capital equipment completed on or after July 1, 1982 costing $10,000 or more if agreed to by the granting agency.

- At one university we found two recharge centers which had not rebated interest expense due to the federal government. The two recharge centers had budgeted for the rebates, but the university had not submitted any payments for the past three fiscal years. The federal portion of interest is based on a ratio of federal usage to total usage.

- In another example, we found that interest income of $690,855 had been earned on the investment of HPLS and NSL program funds both the income earned was not credited to the program as required. We found that the state comptroller had been investing HPSL and NSL program funds. However, none of the earnings on the invested program funds were credited to the fund balances as required. Instead, all the earnings were credited to the state's general bank account and then made available to the state legislature as discretionary funds.

5. **Cost sharing** - Cost sharing is work preformed directly on a research grant or contract that is not charged to the grant or contract. For example, certain principle investigators spend more actual effort on a grant than is billed to the sponsoring agency. This unreimbursed effort is considered to be cost sharing. Prior to 1986, HHS had agreements with various educational institutions which required the schools to cost share some predetermined percentage of their total HHS research effort. The required cost sharing percentages varied from institution to institution. The 1986 HHS appropriation bill removed the institutional cost sharing requirement since it was not equitable among all schools.

According to OMB Circular A-21, cost sharing should be included as part of the organized research base for determining the indirect cost rate to be applied to grants and contracts. Findings on cost sharing pertain to whether colleges and universities are properly identifying cost sharing on research projects and including cost sharing in the development of indirect cost rates.

Past reviews at colleges and universities showed that cost sharing is not always identified and accounted for in the determination of the indirect cost rate. This can result in a proposed rate which is inflated.

- At one school we found that because of poor controls over financial reporting, it could not be determined that amounts reported as cost sharing were reasonable, actually expended on the grants, and not claimed on more than one grant.

- At another university, auditors determined that supporting documentation for cost-sharing was insufficient. For example, a Department of Energy (DOE) grant, required cost sharing in the form of student assistant salaries, equipment rental, and other items. We found that only costs related to one year was adequately supported in the cost sharing files.

6. **Equipment and capital expenditures** - Equipment is defined as nonexpendable tangible personal property having a useful life of more that 2 years, and an acquisition cost of $500 or more per unit. Capital expenditures for equipment pertain to the cost of the asset including the cost to put it in place. These costs may include accessories or modifications or ancillary charges such as taxes, duty, insurance, freight and installation. Under Circular A-21, capital expenditures for equipment, buildings, and land are unallowable as direct charges, except when approved in advance by the sponsoring agency or specified in grants administration policy. In addition, capital expenditures are unallowable as indirect costs unless capitalized. Examples of findings we uncovered in this category included equipment purchases that were expensed instead of capitalized and purchases which were made without prior approval of the contracting officer.

C. Program Specific Category

Table V describes the major types of findings in the program specific category.

Table V

PROGRAM SPECIFIC FINDINGS
BY TYPE

Type of Finding	OIG	Non-Federal	Total	Percent
Billing and Collection	0	37	37	39.8
Eligibility	1	15	16	17.2
Matching Funds	0	5	5	5.4
Other	6	29	35	37.6
Totals	7	86	93	100.0

Findings in the program specific category usually pertain to specific federal programs such as the Nursing Student Loan, Health Education Assistance Loan and Guaranteed Student Loan Programs. In addition, Head Start programs which are sometimes managed and operated by universities and colleges, are included in this category.

1. Billings and Collections

An example of this category of finding follows:

- At one university, we found that expenditures in one of the forty federal awards reviewed were not properly reflected in the financial report. The grant awarded to the university included expenditures of $43,027 to be made by a subgrantee. As a requirement of the agreement, the subgrantee was to provide a financial report and documentation of expenditures prior to reimbursement. In the period reviewed, no documentation was received from the subgrantee and no reimbursements were made. However, the university included subgrantee expenditures in the report submitted to the funding agency.

2. Eligibility

All financial aid programs require that student financial needs be determined as part of the awarding process and that awards be limited to the financial needs of the applicants. Findings in this category generally mean that the university did not adequately screen applicants to determine eligibility. An example of this finding follows:

- At another university, it was found that recipients of the first-year students of Exceptional Financial Need Scholarship (EFN) were awarded financial aid packages that exceeded their financial needs. The same students also submitted applications for loans under the health education assistance loan and guaranteed student loan programs. When the EFN proceeds of the loans requested, instead of withdrawing their loan applications. It was recommended that the university repay $59,600 for all loans overawarded and convert all amounts paid into institutional loans.

- At another university, it was found that students received more than two financial aid awards from the same program during the academic year. In one instance a student was not enrolled in school for the fall semester but a $795 pell grant was posted to the student's account. It was recommended that the university implement procedures requiring the review of student financial aid awards to data contained in the financial aid office. Some students were overawarded financial aid based on enrollment status. The students actually enrolled for fewer hours than the number of hours used to compute their award amount. The university overawarded $8,070 to these students.

3. Matching Funds

Some federal grants require an university to match funds on specific programs, for example, the gerontology curriculum development program. A finding in this category occurs when the university was deficient in providing matching funds as required by the provisions of the federal grant agreement.

- Some federal grants require a university to match funds on specific programs, for example, the gerontology curriculum development program at mississippi valley state university. The non-federal auditors determined that the university was deficient in providing matching funds in this program as required by the provisions of the federal grant agreement.

  Findings in the program specific category usually pertain to specific federal programs such as the nursing student loan, health professions student loan, health education assistance loan and guaranteed student loan programs. In addition, head start programs, managed and operated by one universities and colleges, are included in this category.

Chapter III
OIG Strategies

Over many years we have performed thousands of audits in colleges and universities. Only about 1 percent of the department's outlays are in research grants to universities and nonprofit agencies. Yet, we devote approximately five times that rate as part of our audit work plan. Even this rate represents only a tiny fraction of the resources needed to audit effectively all the schools assigned to our department. It raises serious concerns as to whether it serves the best interest of our department to divert more resources from other programs, such as Social Security, Medicare, and social programs, in order to increase coverage of this area. The better answer has to be in a new approach to oversight related to these institutions.

Our audit findings, special studies, and implementation of OMB circulars and the single audit act have provided us with many insights into the problems in funding research. This knowledge and experience led to the development of a "Long Range Strategy for Reviewing the Financial and Programmatic Research Activities Conducted by Colleges, Universities and Nonprofit Organizations for the Federal Government." Published in, March 1991, the strategy builds upon our body of work and is designed to address systemic internal control problems. In the long range strategy, we define over 40 audit areas of ongoing or planned work. Thirteen areas will address cost containment issues. For example, we will: (1) identify existing governmentwide cost containment initiatives which have been effective and determine if they might be applied to colleges and universities; and (2) review how NIH can better monitor research costs. Ten audit areas will address indirect cost reimbursement issues, and 17 areas will address the federal system for funding research and the adequacy of Federal oversight. We will also identify alternative approaches to monitoring research efforts.

Nine of the significant studies included in the OIG's strategic plan are discussed below.

(1) Review of OMB Circular A-21

In March and April of 1991, several congressional hearings were held which brought to light examples of unreasonable and excessive charges to Federal research. Such items as yachts, antique commodes and liquor were found to have been allocated to research through various overhead accounts. To address this problem, the OMB announced on April 22, 1991, that it planned to revise Circular A-21 to provide more specificity with regard to those administrative and entertainment costs which are unallowable. The HHS Task Force on A-21 will be recommending changes similar to those announced by the OMB, and will address other short term changes. We also will undertake a study to look at long range changes to A-21.

Over the years we have made or supported recommendations to revise A-21 in the area of indirect costs. For example, in a report issued in Fiscal Year 1986, we recommended that departmental administration, one of the administrative cost centers, be capped at 7 percent. Our recommendation was only partially accepted and a fixed rate of 3.6 percent was adopted for certain departmental staff. We also supported a recommendation in 1986 to cap at 26 percent four administrative cost centers -- general administration, departmenal administration, sponsored projects administration, and student services administration. This rate was to eventually be lowered to 20 percent. This recommendation was never implemented. We have summarized and analyzed numerous recommendations and suggestions for revisions to A-21 and have shared this information with other components in our Department, other Federal agencies, and the OMB. We plan to work with the HHS Task Force to further study and develop more broad-based reforms to A-21.

Currently, we are reviewing charges made to indirect costs in 13 colleges and universities. Our reviews will determine (i) whether such charges are allowable and appropriate under OMB Circular A-21 and (ii) the nature of such charges and the degree of their relationship to activities which support the research effort. Our review will concentrate on the general administrative cost pool but may also include tests of the maintenance and operations and other cost centers. Appendix F provides examples of unallowable or inappropriate indirect costs contained in cost pools. Certain charges may currently be allowed under Circular A-21 but may also not have either a direct or indirect relationship to research. Also, some charges although allowable, may be perceived to be extravagant or otherwise inappropriate. We will identify such charges during these reviews. Reviews will also be done at those schools where we are providing assistance to the DCA. The 13 schools included in the review are: Yale, Dartmouth, Rutgers, University of Pennsylvania, Johns Hopkins, University of Pittsburgh, Duke, Emory, University of Chicago, University of Michigan, University of Texas Health Science Center at Dallas, Washington University, and University of Southern California.

(2) Controls over recharge center billing rates

Recharge centers are those units or centers which provide the university with a specialized service on a continuing basis. The centers provide the required services and charge their costs to users on the basis of established rates. Rates should be designed to recover not more than the aggregate cost of goods and services. Each center generally accounts for its revenues and expenses in a separate account known as a recharge center. This review will determine whether universities are adjusting their billing rates for recharge centers on an annual basis to eliminate accumulated surpluses/deficits, ensure that only allowable costs are included in calculating the billing rates.

Typical examples of such centers include data processing, motor pools, telecommunications, supplies, and research animal facilities. Some universities have more than a hundred recharge centers.

At selected universities we will: identify and assess university internal controls over recharge centers, review the components of the billing rates and note whether only allowable costs are included in the rates, determine whether the same rate charged to federal research grants is used to charge other users, and determine whether the operating costs of recharge centers is properly excluded from indirect cost proposals.

For those recharge centers with surpluses we intend to calculate and recommend recovery of any resulting overcharges to federal grants and contracts.

(3) Malpractice insurance

In this OIG study we will review a sample of universities with medical schools to determine how schools are charging medical liability insurance costs. OMB Circular A-21 does not provide specific guidance on the charging of medical liability insurance cost. However, the circular allows insurance which is required or approved and is maintained pursuant to the sponsored award. It also allows insurance (with certain limitations) maintained by the institution for the general conduct of its activities.

Previous reviews in the area of medical liability insurance have shown that colleges and universities have been inconsistent in charging this cost to federally-sponsored research. Some universities were charging medical liability insurance to federally-sponsored research which received no benefit from this insurance.

(4) Analysis of research direct costs

This review will focus on how NIH funds are used by colleges and universities. Budgets in the award documents contain costs by line item; however, there are no restrictions on moving funds between budget line items. Expenditure reports are not required to show how funds are actually spent. Are we getting what we intended to pay for? Our review will also consider what information NIH actually needs to properly monitor research costs. We will begin this initiative by creating a national data base of budgeted amounts by cost element. A sample of grants will be selected from the data base. Regions with grants at schools located within its region will consider using tiger teams to document actual expenditures on each grant.

(5) Utilization of research equipment

This study will determine whether federal sponsoring agencies and public and private schools are effectively managing equipment purchased with federal funds. Is equipment that has been purchased being used? Do colleges and universities maintain on a current basis detailed inventory records? Do colleges and universities have a screening process to avoid the purchase of unnecessary and duplicative equipment? Do they determine if equipment purchased for use on federal research can be used on other grants and contracts? We will also determine whether federal agencies make maximum use of the government's right to transfer title to the federal government or other third parties.

(6) Review of infrastructure - facilities replacement

This review will determine (1) if new construction or renovation of existing facilities is reasonable and necessary in support of federal research; and (2) the impact of interest costs, use allowances and other capital costs related to facility replacement on indirect cost rates.

Billions of dollars are expected to be spent on constructing and renovating research facilities over the next several years. The federal government does not participate in these outlay decisions even though it pays for a substantial portion of the outlays through research grants and contracts.

Infrastructure costs are defined as capital expenditures for the construction of new buildings and/or the renovation of existing facilities. Capital costs, which include interest expenses and depreciation or use allowances, are reimbursed as part of indirect costs charged to grants and contracts.

Infrastructure related costs are perceived to be one of the fastest growing components of indirect costs. For example, in 1989 infrastructure related costs for a major eastern university accounted for 4.8 percent of the total proposed indirect costs. For 1992, the university's infrastructure related costs is estimated to rise to about 11.1 Percent of total indirect costs, an increase of 131 percent. For the same time period, the university's overall indirect cost rate is estimated to rise from 66.1 percent in 1989 to 74 percent for 1992 - an increase of almost 12 percent.

Universities can control the federal share of infrastructure related costs merely by shifting research activities into buildings of its choosing. The federal government is usually not aware that this is occurring since infrastructure costs are included in indirect cost pools.

The liberal reimbursement of infrastructure costs via indirect costs may have encouraged universities to undertake major construction projects to increase and upgrade their research space. This upgrading helps universities to compete for additional research grants and to attract and retain top principal investigators and graduate students. In the short term, however, the federal government may be paying higher indirect costs for the same level of research output while universities simply substitute new research space for old research space.

The significant increases in infrastructure related costs could increase as more universities take advantage of the system which allows them to upgrade their research facilities knowing that the federal government will share in the costs. The more aggressive universities may even embark on an infrastructure "arms race" to acquire the most modern research facilities in order to obtain a competitive edge over other institutions and as a way of enhancing its own "prestige."

At selected universities our review will determine if the infrastructure costs of new or renovated facilities was an economically and necessary alternative to support federal research.

(7) Application of cost caps

This review will determine the feasibility of caps for research salaries, other direct costs and indirect costs. We will: a) survey other agencies and departments regarding their application of caps on salaries and other costs, and b) determine which cost categories, if any, may be best controlled through the use of caps. We will determine whether current salary caps are working as intended. Many researchers on federal grants do not make over $125,000. Those researchers that exceed the limits are for the most part medical doctors, at the medical research universities. In this regard, various caps may be needed depending on the type of position. We will consider the appropriateness of the use of caps by type of position, by region and by type of institution.

In 1966, when indirect cost ceilings were lifted, mandatory cost sharing was required of grantees. However, mandatory cost sharing was eliminated in 1986 and indirect ceilings were never reimposed. We will research and study ways of improving the indirect cost process as well as methods of providing incentives for containing the administrative costs associated with research.

(8) Identify total research effort indicating cost sharing

This review will determine if colleges, universities and nonprofit organizations are properly identifying cost sharing on research projects and if they are properly including cost sharing in the development of indirect cost rates. This review will also examine the merits of making cost sharing a mandatory part of federally supported research at colleges and universities. Their is support for mandatory cost sharing as a simple method of increasing the amount of total research at colleges and universities.

Work performed directly on a research grant or contract that is not charged to the grant or contract is commonly referred to as cost sharing. According to OMB Circular A-21 cost principles for colleges and universities and OMB Circular A-122 for nonprofit organizations, if cost sharing occurs, even though voluntary and informal, it should be included as part of the organized research base for determining the indirect cost rate to be applied to grants and contracts.

Past reviews at colleges and universities and nonprofit organizations showed that cost sharing is not always properly identified and accounted for in the determination of the indirect cost rate. This can result in a negotiated rate which is inflated. The extent of such practices and their impact on research costs will be examined during this review.

(9) Review of indirect costs claimed for subcontract costs

This study will determine if universities are properly excluding subcontract costs from the direct costs base prior to applying the indirect cost rate. Under Circular A-21 schools are to distribute indirect costs to applicable sponsored agreements on the basis of modified total direct costs (mtdc), consisting of salaries and wages, fringe benefits, materials and supplies, services, travel and subgrants and subcontracts up to $25,000.

Some universities may not be applying the $25,000 limit in a consistent manner. Rather, some universities may be including these subcontract costs on an annual basis rather than the one time addition. This practice would increase indirect costs recovery and, as a result, increase federal costs.

Our review at selected universities will determine if the provisions of A-21 with respect to the limits on subcontracts are being properly implemented.

Chapter IV

Future Options

Our audit findings and experience over the years lead us to believe that there must be better ways for the Federal Government to deal with reimbursement for research efforts on grants and contracts at colleges and universities. There are many options for better ensuring that the dollars available produce the maximum support for scientific research. We have identified a number of options that might be considered for further study, including:

- Indirect Cost Rates

  Significantly amend, as OMB proposes, or modify Circular A-21 to ensure that certain specific costs are excluded from indirect cost reimbursements paid to colleges and universities receiving Federal research grants.

- Block Grant

  Block grant research dollars to universities. Under this option, institutions would be given a set amount of money to meet the joint governmental institution research goals. The institution would determine how much would go for direct and indirect costs.

- Principal Investigators

  Award research dollars to principal investigators. The investigator would then be responsible for including in their proposals the indirect cost component at the school where the research will take place. The investigator and the school would be forced to negotiate direct and indirect costs.

- Standardized Accounting Systems

  Mandate a standardized accounting system for the major colleges and universities hosting Federal research grants that would reduce variations among schools as to how they account for and allocate costs.

- Cap

  Place a cap on the indirect cost rate. For example, limit the indirect cost rate to the mean or average rate. Under this option, the savings from capping indirect costs could increase the number of grants and funding levels for science.

- Limit Rates

  Limit future indirect cost rates at a level which does not exceed the school's 1991 negotiated rate.

- Lowest Level Charged

  Limit the indirect cost rate for Government research grants to the lowest level charged by the institution to other U.S. and foreign entities. The OIG has observed differential treatment for research funded by the Government vs. Research performed on behalf of U.S. and foreign corporations and foundations.

  Both public and private schools charge a lower indirect cost rate to foundations, public corporations and foreign Governments for research projects than they do to the U.S. Government for federally funded research. Some schools waive the indirect cost rate, even for a million dollar contract with a publically traded corporation. Schools with a Federal indirect cost rate as high as 77 percent waive or reduce the rate with other entities to as little as 6 or 10 percent. Others have a sliding scale, for the indirect cost rate, using whatever rate can be negotiated. It appears clear from this anecdotal information that schools may be looking to the Federal Government to cover the overhead associated with research performed for nonfederal and foreign entities.

- Cost Sharing

  Mandate "cost sharing" for research, i.e., the school would contribute a percentage of the total cost of research. This notion of cost sharing was previously in place but was found to be inequitable among schools. The practice was discontinued in 1986. With additional thought and work, cost sharing might be feasible. It was not equitable among all schools, so the practice was discontinued. With additional thought and work, cost sharing might be feasible.

- Add-on Costs

  Limit indirect costs to only those expenditures that are add-on costs to the institutions for supporting research. Those university costs that would be incurred whether or not the research was being conducted would thereby not be eligible for indirect cost support.

- Fundings for Oversight

  Increase funding levels for Federal oversight efforts (audit and cost allocation work at educational and nonprofit institutions.

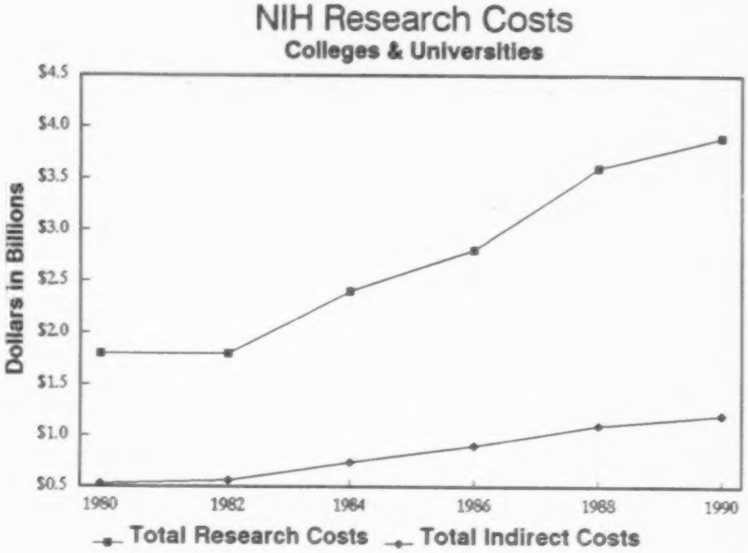
- Agency Specific Negotiations

  Do away with governmentwide rules, and allow granting agencies to negotiate the rates for their agencies' grant programs separately. Currently, at NIH, for example, scientists submit proposals for new grants to scientists. However, the indirect cost rates are negotiated without either scientific party. It takes place between the accountants at the university finance office and the accountants for the Department. The proposed option would mean an agency could negotiate a rate for all their grants by discipline. In this way, biomedical research and social research costs could have different rates.

- Recovery

  Seek legal authority for the actual recovery of inappropriate expenditures charged to indirect cost pools and for their return for programming for future funding of science. Currently, when auditors note findings which are sustained, there is no check that is tendered back to the program for future use in scientific research. The general practice is to offset the amount against future indirect cost rates. In some cases there may be adjustments between the direct and indirect cost pools. The net effect is that the money seldom leaves the campus. On some fairly rare occasions, there have been checks written to pay back the money. However, the funds do not go to be reprogrammed for new research, but to the general fund of the treasury. The system does not lead to much in the way of accountability or incentives for efficient use of those funds.

APPENDIX A


NIH Research Costs
Colleges & Universities
Dollars in Billions
$4.5
$4.0
$3.5
$3.0
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$1.5
$1.0
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1988
1990
■ Total Research Costs
◆ Total Indirect Costs

Appendix B

OMB CIRCULARS

A-21	COST PRINCIPLES FOR EDUCATIONAL INSTITUTIONS Provides to colleges and universities, as well as Federal Agencies, the principles for determining the costs applicable to research and other work performed under federally sponsored agreements.
A-88	INDIRECT COST RATES, AUDIT AND AUDIT FOLLOW-UP AT EDUCATIONAL INSTITUTIONS Establishes indirect cost rates, auditing, correcting systems deficiencies and resolving questioned costs.
A-110	UNIFORM ADMINISTRATIVE REQUIREMENTS FOR GRANTS AND OTHER AGREEMENTS WITH INSTITUTIONS OF HIGHER EDUCATION, HOSPITALS AND OTHER NON PROFIT ORGANIZATIONS Provides guidance to grantees and contractors for financial management of federal funds received.
A-128	AUDITS OF STATE AND LOCAL GOVERNMENTS Establishes audit requirements for State and local governments receiving federal aid and defines federal responsibilities for implementing and monitoring those requirements.
A-133	AUDITS OF INSTITUTIONS OF HIGHER EDUCATION AND OTHER NON PROFIT INSTITUTIONS Establishes audit requirements and defines federal responsibilities for colleges and universities. Requires schools have audit of federal awards every two years.

DIRECT AND INDIRECT RESEARCH COSTS - TOP 20 COLLEGES AND UNIVERSITIES
BY COGNIZANCE
(DOLLARS IN THOUSANDS)

INSTITUTION	COGNIZANCE	TOTAL R&D AWARDS*	ESTIMATED INDIRECT COSTS	DIRECT COSTS	INDIRECT COST RATE AS A PROPORTION OF DIRECT COSTS
STANFORD UNIV.	DOD	$239,847	$100,401	$139,446	72.00%
JOHNS HOPKINS UNIV.	HHS	211,879	83,467	128,412	65.00%
MASS. INST. OF TECHNOLOGY	DOD	207,157	75,629	131,528	57.50%
UNIV. OF WASHINGTON	HHS	203,691	70,560	133,131	53.00%
UNIV. OF CALIF. @ LOS ANGELES	HHS	170,839	55,407	115,432	48.00%
UNIV. OF MICHIGAN	HHS	167,865	62,290	105,575	59.00%
UNIV. OF CALIF. @ SAN DIEGO	HHS	166,601	54,788	111,813	49.00%
UNIV. OF CALIF. @ SAN FRANCISCO	HHS	159,027	44,206	114,821	38.50%
UNIV. OF WISCONSIN @ MADISON	HHS	150,474	45,978	104,496	44.00%
COLUMBIA UNIVERSITY	DOD	150,263	63,955	86,308	74.10%
YALE UNIVERSITY	HHS	146,245	59,194	87,051	68.00%
HARVARD UINVERSITY	HHS	141,760	58,616	83,144	70.50%
CORNELL UNIVERSITY	DOD	139,954	52,663	87,291	60.33%
UNIV. OF PENNSYLVANIA	HHS	132,805	52,317	80,488	65.00%
UNIV. OF CALIF. @ BERKELEY	HHS	131,070	43,104	87,966	49.00%
UNIV. OF MINNESOTA	HHS	128,727	39,333	89,394	44.00%
PENNSYLVANIA STATE UNIV.	DOD	119,435	39,652	79,783	49.70%
UNIV. OF SOUTHERN CALIFORNIA	HHS	114,766	43,261	71,505	60.50%
DUKE UNIVERSITY	HHS	108,611	36,204	72,407	50.00%
WASHINGTON UNIV.	HHS	102,974	39,410	63,564	62.00%
TOTAL/AVERAGE		$3,093,990	$1,120,435	$1,973,555	56.77%

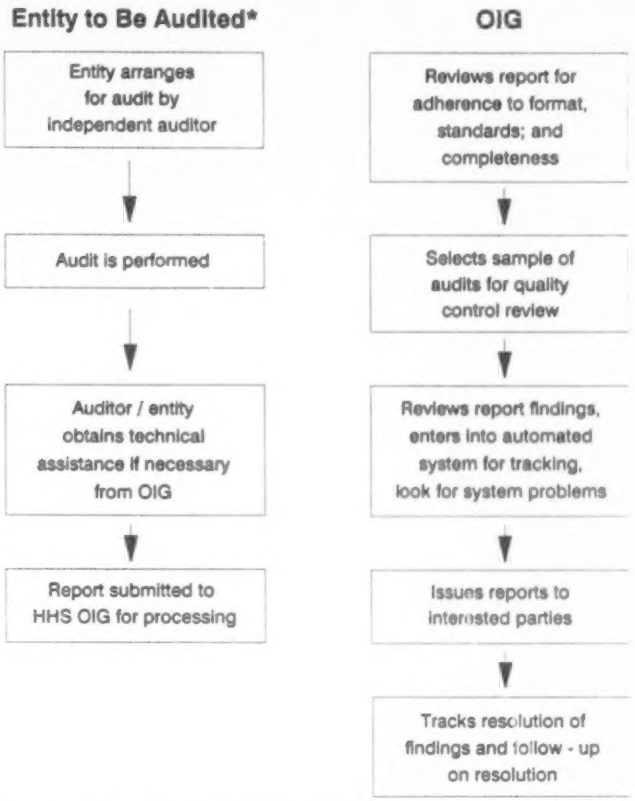
* FY 1989

Weighted Average Indirect Cost Rates In Major Colleges and Universities By Cost Center and Total
1982 - 1991

	82	83	84	85	86	87	88	89	90	91
General and Administrative	7.34%	7.12%	7.33%	7.40%	7.23%	7.15%	7.29%	7.27%	7.32%	7.30%
Departmental Administration	14.04%	15.33%	15.63%	15.47%	15.87%	15.55%	15.75%	16.06%	16.07%	16.09%
Sponsored Projects Administration	3.26%	3.11%	2.98%	3.18%	3.29%	3.33%	3.11%	3.14%	3.26%	3.27%
Student Services	0.53%	0.19%	0.11%	0.15%	0.17%	0.16%	0.14%	0.16%	0.15%	0.17%
Library	2.05%	1.99%	1.97%	2.14%	2.17%	1.98%	2.05%	2.05%	2.03%	2.04%
Depreciation / Use allowances	4.17%	4.36%	4.57%	$4.71%	5.04%	5.22%	5.44%	5.82%	6.27%	6.46%
Operation & Maintenance	11.95%	12.59%	13.26%	14.05%	14.38%	14.76%	14.95	15.01%	15.47%	15.68%
Other / Misc	0.96%	1.18%	1.24%	0.71%	0.60%	0.65%	0.22%	0.02%	0.00%	-0.02%
Weighted Average Negotiated Rate	44.30%	45.88%	47.09%	$47.84%	48.77%	48.80%	48.95%	49.53%	50.57%	50.99%

Appendix E

Responsibilities of Entities and the OIG Under Circular A - 133


Entity to Be Audited*
OIG
Entity arranges for audit by independent auditor
Audit is performed
Auditor / entity obtains technical assistance if necessary from OIG
Report submitted to HHS OIG for processing
Reviews report for adherence to format, standards; and completeness
Selects sample of audits for quality control review
Reviews report findings, enters into automated system for tracking, look for system problems
Issues reports to interested parties
Tracks resolution of findings and follow - up on resolution

*Audits are to be performed at least once every two years at colleges, universities or nonprofit organizations receiving $100,000 or more.

Appendix F

EXAMPLES OF UNALLOWABLE OR INAPPROPRIATE INDIRECT COSTS CONTAINED IN COST POOLS

- President's and Trustee travel includes wife
- Travel expenses for Trustees who donated their travel and did not receive reimbursement
- Trustee banquet charges for such purposes as alumni clubs, commencement and student breakfasts
- Chauffeuring for the President and Trustees. Some chauffeuring for President's wife
- President's official entertainment to financially support his responsibilities as president
- One hundredth anniversary celebration for a seniors society
- Legal expenses relating to:
    - suit regarding violation of student's civil rights
    - U.S. Justice Department anti-trust suit
    - private suit regarding price fixing of tuition
    - graduate student suit relating to explosion in laboratory while student working on thesis
    - family suit relating to drowned student
    - real estate development for affordable housing for faculty
    - academic plagiarism
- Depreciation for equipment no longer in use
- Depreciation for athletic equipment
- Administrative expenses for a shopping center
- The cost of producing a community report to promote university activities
- Advertising to promote student attendance at summer session and on career week
- Fund raising
- Student activities such as, fraternity task force, bands for student dance, van rentals for student luggage, furniture for student clubs

Mr. **Kusserow**. Let me go back to your question, though. That is, indeed, I would say that, unfortunately, the way the system operates, it invites gamesmanship. It invites the notion that, "We'll put as much as we can in the indirect cost pools, and if you can find it, we'll take it out."

I don't think that's what this is all about. We're trying to advance science; we're not trying to see how much somebody can get in the indirect cost pool and how much the Federal Government can subsidize beyond what they should at a university. So it does have all the elements of gamesmanship.

Mr. **Rowland**. Well, in fact, if this is gaming unallowable cost, would you say that could be bordering on fraud?

Mr. **Kusserow**. Well, the problem that we have on that is, as I had mentioned, when they had—when OMB had moved to clarify the abuse in the area of A-21, they took out things like "entertainment." I have a very difficult understanding as to how anybody could say that liquor for any purpose advances science. Why was that allowed at all in the first place? It was appropriate. It was legal. They could do it. They could claim it. We could argue why it was not appropriate, and we could probably get it out, but why should they have had that in there at all as an argument.

The same thing about luxury travel or promotion and lobbying, the excessive salaries, those kinds of things—those were permissible, but they were abused. In my mind, it's clear that a fraud is where you violate the law, but an abuse is where you're getting away with something that you really were not intended to have, but is not against the law. I would say it's in the area of an abuse, certainly not a fraud.

Mr. **Rowland**. Not a fraud. Then your office is not looking at any criminal investigations based on the information that you have accrued so far?

Mr. **Kusserow**. No, there is no evidence of any criminal fraud, or intent to defraud the Government, or violations of the Criminal Code in any of the work that we have been doing over the last several years.

We have occasionally gotten into a situation where there was an embezzlement of money from a research grant, in which case we prosecuted those, but this is not that kind of a problem here.

Mr. **Rowland**. Let me ask you this, Mr. Kusserow, your report also describes the situation at one university where a weakness in the department's purchasing function allowed an employee to establish a fictitious company and embezzle over $400,000 from federally-sponsored research projects.

Mr. **Kusserow**. Yes, sir.

Mr. **Rowland**. Which university was this? Could you explain the situation in greater detail?

Mr. **Kusserow**. That was the University of California at San Francisco. It was an embezzlement of $400,000. The investigation was conducted by our office. It was an embezzlement from the grant, itself, not from the indirect cost pools. The individual was convicted and sentenced and ordered to pay full restitution. A check did come back to the Government for that.

Mr. **Kusserow**. There are several universities that you have listed here on page 14 of your testimony. I would like to ask you some questions about those, but I see my time has expired. So, I will ask the chairman that I would like to do this when you come back to me.

Mr. **Dingell**. The Chair thanks the gentleman. The Chair recognizes the gentleman from Virginia, Mr. Bliley.

Mr. **Bliley**. Thank you, Mr. Chairman.

Mr. Kusserow, I would like to discuss with you the philosophy of the indirect cost recovery. I know that politicians sometimes sound silly when they talk about philosophy, but I think it is important here. Because the underlying philosophy will govern the appropriateness of the specific transaction that a university includes in its indirect pool.

Has the philosophy of indirect cost reimbursement been to reimburse for the average cost to the university of doing research for the Federal Government, or for the marginal cost to the university for doing research?

Mr. **Kusserow**. The problem is that it is not really the latter. You do not—if it were just simply a question of what is the increase of burden to the university as a result of hosting research, then the Federal Government, quite frankly, should pay the entire amount. There should be no question about it.

The difficulty that you have is that A-21, which is again a document that, quite frankly, anybody other than an attorney, accountant or an auditor would have great difficulty in understanding. It isn't put on that basis where it is a cost added to the university, being paid for by the Government for hosting Federal research.

So, you have this very complicated process by which you try to allocate from the entire university function the unallocated overhead to support their research. Believe me, if that sounds confusing, it really is confusing. If we could have a situation where we would pay for the increase—if you will, the variable cost increase to a university or to any institution for hosting research, I think that would be a much preferable way to do business.

Mr. **Bliley**. How would a subsidy to a university differ from indirect cost reimbursement, based on the average cost of running a university?

Mr. **Kusserow**. I am sorry, I missed the first part, sir.

Mr. **Bliley**. How would a subsidy to a university differ from indirect cost reimbursement, based on the average cost of running the university?

Mr. **Kusserow**. Than if—and I am not quite sure I have your question right, but let me see if I can answer it. Let's talk about the philosophies, the conflicting philosophies that you probably have heard and will be hearing in the future. That is what we are talking about, certainly from our view point is that we grant and accept the fact that the treasure house of America are the universities and colleges of the United States.

However, this money is not for the purposes of advancing those institutions, as noble as it is, it is to advance science. What we feel that we should pay the universities for is the cost to them for advancing science for hosting research. They should not receive more than that. We should not be subsidizing the university for its normal responsibilities of educating the youth or for other functions that they have that are noble and are desirable, but not with the money that should go to science.

If it is the philosophy or if it is the policy of the U.S. Government to support those institutions, it should not come out of this pot, it should come out of a different pot. I think therein lies the basic problem. That is, we are not subsidizing the universities to operate, we are reimbursing the universities for the cost to them for housing our research. Did that get to your question, sir?

Mr. **Bliley**. That got it. One other thing I want to ask, to follow up on. I gathered, from your testimony, that you agree with my position that if these universities make these outrageous charges to the Federal Government that not only should we recover the principal, but we should recover interest for the time that they had the use of the money.

Mr. **Kusserow**. I think I probably betrayed myself when you had made that assertion, and I grinned. Because I, in fact, think that's exactly right. I think that if somebody inappropriately expends or spends money, they are not entitled to—they have an unjust enrichment, that they should have to return it and they should not—the Government should not be out that money. So, any interest that is lost should be, in fact, made up by the offending institution.

If all you do is move the money around the campus, either into a different indirect cost pool or rolling it forward or moving from the indirect to the direct, then I am not sure that you have a disincentive for people trying to gain the system. If they have to return the money with a check with interest, I think that is—at least it is a statement to them that we do not want them to do that, and I think that is important.

Mr. **Bliley**. Thank you. Thank you, Mr. Chairman.

Mr. **Dingell**. The Chair thanks the gentleman. The gentleman from Minnesota, Mr. Sikorski.

Mr. **Sikorski**. Thank you, Mr. Chairman.

Mr. Kusserow, in your testimony today, you cited 12 schools that have voluntarily made adjustment to their administrative cost pool, either based on your audits or on their own reviews. Taking them one at a time, I would like you to inform the subcommittee of specific examples found at each institution. The first one is Dartmouth, where more than $1 million was removed. Tell us what you found, specifically, at Dartmouth.

Mr. **Kusserow**. Well, if you go down to Dartmouth, first of all, thus far, we questioned $1,066,000 in the indirect cost pool. Dartmouth voluntarily came forth, recommending an adjustment to their own pool only for $111,785. However, they have agreed, thus far, to $764,031. So, it is pretty much of a mixed bag.

As to the kinds of things that we have come up with at Dartmouth, where we are questioning it, we have found, for example, where we have questioned legal expenses, in one case, to a—in regards to a U.S. antitrust suit, where they were defending against it, miscellaneous real estate, off-campus newspaper, price fixing tuition, academic plagiarism costs, university writing procedures, president's college activities, senior society anniversary celebration, administrative sabbatical. There is a whole host of things. I would be pleased, if you would like, to give you a complete listing of that.

Mr. **Sikorski**. Why don't you provide that to the subcommittee on each of these. As I understand, in terms of the numbers, there are two things we are looking at, in specifics, numbers and stuff. The numbers we have are the $1,066,000 that your review says——

Mr. **Kusserow**. Is questioning, yes.

Mr. **Sikorski**. They said $111,000, and they had——

Mr. **Kusserow**. Which they had volunteered on their own.

Mr. **Sikorski**. They have agreed to 764, at this point?

Mr. **Kusserow**. Thus far, to take out of that pool.

Mr. **Sikorski**. We are talking about antitrust defense; we are talking about price-fixing defense; and we are talking about——

Mr. **Kusserow**. Library maintenance.

Mr. **Sikorski**. Academic plagiarism defense. The next example is Yale, where $720,000 was removed. What are the——

Mr. **Kusserow**. Well, it has not been removed. Now, again, I would want to emphasize what——

Mr. **Sikorski**. Had not been removed?

Mr. **Kusserow**. No. We are questioning at this time. Understand on almost all these cases, they have not, as yet, done this. They want to include this in the pool, so that when they get the new reimbursement rates, the indirect cost rates, that it would incorporate those expenditures and that would then raise their indirect cost rates up.

Mr. **Sikorski**. Wait a minute. We should understand this.

Mr. **Kusserow**. Yes.

Mr. **Sikorski**. This is the old cost-plus basis?

Mr. **Kusserow**. Basically what it is is that on a cycle, generally about every 3 years, we set an indirect—and I'm really kind of treading over into my colleagues here.

Mr. **Sikorski**. Wait a minute. Before you get ahead of me, what they are proposing, as a principle of dealing with this issue, is to negotiate numbers and then include that in the base, so that we overpaid them originally and then we are going to—they are going to pay back with a base rate that their new indirect cost figures are going to be determined on, with that inflated amount.

Mr. **Kusserow**. Generally speaking, that is right. If you have a copy of the report——

Mr. **Sikorski**. It is a good deal for them, not a good deal for taxpayers, right?

Mr. **Kusserow**. Yes, sir. If you look on——

Mr. **Sikorski**. This kind of adds insult to injury.

Mr. **Kusserow**. Yes, sir.

Mr. **Sikorski**. No one has learned anything about the game? It is kind of catch us if you can and then when they are caught, it is like, we will try another game here?

Mr. **Kusserow**. In many cases, that's precisely what we encounter. It is sort of like their accountants try to get as much included in the indirect cost pools and then gain approval to roll it forward, as their indirect cost rates in the report that——

Mr. **Sikorski**. These people should be working for the Federal Government. We have a debt. They could come up with a—I mean, when new math was discovered, they have taken it to a higher or lower level.

Mr. **Kusserow**. Well, I would emphasize that it is not usually on—it is not always on this level. In our report, we have a table in there that really is worth examining by the committee, where it really talks about the indirect proposed cost rate. Then they talk about the cost that is actually negotiated and the differential. I think it is——

Mr. **Sikorski**. Are we allowing them to use these numbers in their base rate?

Mr. **Kusserow**. No, sir. That is what we are taking out on the front-end side.

Mr. **Sikorski**. So, the message should go forward to everyone that——

Mr. **Kusserow**. Do not do it. Do not try it.

Mr. **Sikorski**. Do not even ask.

Mr. **Kusserow**. Do not even try it. Yes. Do not even ask.

Mr. **Sikorski**. Get credit for creativity, but you are going to get debits for the bad public relations.

Mr. **Kusserow**. That goes back to—Mr. Bliley's point though is that if they had managed to get away with it and the post-audit review were to uncover it, they should be penalized in some way. One way to penalize them is to ask them to return not only the money that they expended, but also interest lost.

Mr. **Sikorski**. That is what you are doing?

Mr. **Kusserow**. Well, we cannot—yes, there is not a provision for that. That is worthy of exploration though by this committee it seems to me. That is that, if you could develop a mechanism where not only do you get the money back plus interest, but it goes back to science, and does not go back to the general fund, but somehow gets recycled back into research. There are impediments to that that would require a lot of legislation assistance.

Mr. **Sikorski**. I side-tracked us. The Yale—their $720,000 was questioned. What are the specifics there—the kind of stuff that people are focusing on there?

Mr. **Kusserow**. First of all, at Yale, they came forth voluntarily. In this case, out of that $720,000, were $393,000 which they requested to be deleted from their indirect cost pools, as a result of their own internal audit activity. So, they have agreed to take that much out of it. Their balance, we are still working on.

Rutgers came forward with $4 million.

Mr. **Sikorski**. Before you go through that——

Mr. **Kusserow**. Yes.

Mr. **Sikorski**. What were the kinds of things that we are talking about here?

Mr. **Kusserow**. Financial student aid; flowers; a memorial service for a past president; gifts, such as framing and artwork; you have election ballots for the alumni fellows, the cost of that was included; president's travel; fund raising.

Mr. **Sikorski**. Public financing? Is this public financing of election for fellows?

Mr. **Kusserow**. On campus, yes. President's travel; and for fund raising purposes. We have a whole series of housing expenses that we were questioning for the president, the provost, the university secretary, development officer.

Mr. **Sikorski**. Sir, can you jump to Rutgers, where $4,894,000——

Mr. **Kusserow**. We have not really fully examined that yet. Rutgers has come forward and said, as a result of their own internal examination, that that sum is what they feel should be adjusted.

Mr. **Sikorski**. That is the voluntary sum?

Mr. **Kusserow**. Yes, sir. We are, as yet, have not got the back-up records to determine what it is that was represented by that number.

Mr. **Sikorski**. Johns Hopkins is $175,000?

Mr. **Kusserow**. Yes. $97,000 was what they came forth with—the balance has additional questions that we are placing to that. That included such things as catered affairs, receptions, tent rentals for parties, liquor, flowers, president's trip to Europe, dues for the Association of American Universities, things of that sort.

Mr. **Sikorski**. Hopkins is the single largest recipient in Federal Research among the universities.

Mr. **Kusserow**. I should probably point out that there really are two pots for Johns Hopkins. They have the applied civics—or physics lab, which is about $400 million in funding that comes from the Defense Department, that is a Defense-cognizant responsibility. The panel that follows could address that. Roughly $100 million is on the university-side for medical, primarily, and that is the side we are looking at here.

Mr. **Sikorski**. So, they got about $400 million in the defense pot and $100 million in a medical pot, and of the $100 million, they have come up with $175,000?

Mr. **Kusserow**. We have come up with that—of which $97,000 was what they said, as a result of their own internal audits, that they would request—they have voluntarily requested be——

Mr. **Sikorski**. What kinds of things are there?

Mr. **Kusserow**. Well, as I mentioned, there is the catered affairs, the receptions, the——

Mr. **Sikorski**. I am sorry, you did mention liquors and flowers. I take it, from the numbers, this is only a beginning at Johns Hopkins?

Mr. **Kusserow**. Yes. There is more to come.

Mr. **Sikorski**. Pennsylvania, $941,000?

Mr. **Kusserow**. Yes. They did not volunteer anything.

Mr. **Sikorski**. No volunteer?

Mr. **Kusserow**. No. We are going to be—that looks like an arm wrestling effort; but we have alumni mailings there, alumni activities, flowers, president's house, those kinds of——

Mr. **Sikorski**. This is not the volunteer State. Pittsburgh is $259,000?

Mr. **Kusserow**. Yes, sir. Pittsburgh is $259,000, at this point. They have, thus far, only agreed to $39,627 as what they are willing to——

Mr. **Sikorski**. What kind of things were there?

Mr. **Kusserow**. Well, they had—the Office of the President had the leased cars, the drivers; the mobile phones; Christmas cards; a wonderful trip to the Grand Cayman Islands for the president's wife; trip to Dublin for football game, for the president's wife; alcoholic beverages; president's annual giving fund; golf club membership; symphony and opera seats; business dinners and luncheons;

recruitment costs; just a whole wide variety of interesting little tidbits.

Mr. **Sikorski**. Can you tell me where at Duke, at $906,000, have they volunteered any of that?

Mr. **Kusserow**. No, sir, they haven't.

Mr. **Sikorski**. And what kinds of things—there's an art museum there that peeks your imagination?

Mr. **Kusserow**. Yes, sir. There's miscellaneous costs for an art museum expense, and again, in addition to that, they have flower arrangements for the art museum, also a whole wide variety of miscellaneous flower arrangements for various types of entertainment activities, and there are other entertainment expenses, public relations expenses, receptions at the art museum, Founder's Day expenses, faculty dinner and dance gifts, tickets to the opera, gala tickets, tickets to the art museum. Wine for the vice president was included. We also identified art museum costs that were charged to the Office of the President Fund code.

So there's a lot of little things in there that——

Mr. **Sikorski**. Emory is $672,000. Anything volunteered there?

Mr. **Kusserow**. No, sir, nothing volunteered at Emory.

Mr. **Sikorski**. And is it the same stuff, flowers and——

Mr. **Kusserow**. Generally speaking. The president's membership in social clubs. You have—such as the Capital City Club. The universities feel that as a mover and shaker, they need to belong to the mover-and-shaker clubs and that somehow——

Mr. **Sikorski**. Mover-and-shaker's club?

Mr. **Kusserow**. Well, that's—quotes—that's my words.

Mr. **Sikorski**. Oh, there isn't—they don't——

Mr. **Kusserow**. No, sir.

They want—they feel that the president really should——

Mr. **Sikorski**. To call it that is not as prestigious as the Ivy Club or something like that.

Mr. **Kusserow**. Well, they also have—we did have instances where they did try to put into the indirect costs payments for liquor purchased for a party for the new president, expenses for the president's wife to entertain the university's Board of Visitors, a number of different dinners and lunches, a Christmas party, and a variety of things of that sort.

Mr. **Sikorski**. Now the last question here is: The University of Michigan has not made a review to reduce its cost pools.

Do you mean that they have not completed their review or that Michigan, to date, has not conducted any kind of review to determine potential overbillings?

Mr. **Kusserow**. It's just too early yet for Michigan. We just haven't got any details available as yet to report on.

Mr. **Sikorski**. You will submit any—those details to the subcommittee as they come about?

Mr. **Kusserow**. Yes, sir, I will.

Mr. **Sikorski**. Chicago is $348,000? Anything volunteered there?

Mr. **Kusserow**. No, sir.

Mr. **Sikorski**. And the same kind of things?

Mr. **Kusserow**. Yes. The president's office expenses, legal expenses.

Mr. **Sikorski**. Legal expenses?

Mr. KUSSEROW. Yes.

Mr. SIKORSKI. Texas Southwestern Medical Center at Dallas, $32,500. What was that on?

Mr. KUSSEROW. That's also, in the very early stages, a dinner party, valet parking for the dinner party, 10 crystal decanters engraved with the university's seal from Neiman-Marcus, a local store of some renown.

Mr. SIKORSKI. A local mom-and-pop store.

Mr. KUSSEROW. A local mom-and-pop store.

A donation in the name of the president, balloons for a reception——

Mr. SIKORSKI. Donation to whom?

Mr. KUSSEROW. In the name of the president of the institution to the American Jewish Congress honoring a supporter from them for the institution.

Imprinted beverage and lunch napkins purchased from the Junior League of Dallas, development activities with donors and prospective donors, books purchased again for donors to the endowment funds that were purchased from Neiman-Marcus, things of that sort.

Mr. SIKORSKI. Maybe—I know I've gone long, and there's the others on the list. Maybe you can supply for the record the numbers and the kinds of things——

Mr. KUSSEROW. I will give a complete—give a complete listing and accounting.

Mr. DINGELL. The Chair has been permitting the gentleman to proceed beyond the time——

Mr. SIKORSKI. I know.

Mr. DINGELL. Because I thought that the work the gentleman was doing was valuable.

The Chair will continue to recognize the gentleman if——

Mr. SIKORSKI. I thank you for the pat. I didn't want to overstep my bounds.

Mr. DINGELL. No, the gentleman—the Chair has been cognizant of these matters. The gentleman can proceed a little more, if he wants.

Mr. SIKORSKI. Thank you. The University of St. Louis, $985,000, among other things—I'm sorry—Washington University at St. Louis. Among other things, there's donations come in and a statue was bought and paid for?

Mr. KUSSEROW. Yes. A sculpture. There was also severance pay for a tenured professor. Also the cost of preparing a history of the school, certain inappropriate housing costs.

Mr. SIKORSKI. Preparing a history of the school?

Mr. KUSSEROW. Yes.

Mr. SIKORSKI. What is it, a book or a statue, or what is it?

Mr. KUSSEROW. Well, it's basically——

Mr. SIKORSKI. Preparing or repairing?

Mr. KUSSEROW. Preparing.

Mr. SIKORSKI. Oh, I'm sorry. I thought they were repairing it.

Mr. KUSSEROW. I think I should add——

Mr. SIKORSKI. This statue was bought and paid for, as I understand it, with contributions that people gave.

Mr. KUSSEROW. That's right. And then after——

Mr. SIKORSKI. And then after it was bought——

Mr. KUSSEROW. Then they tried to put that into the indirect cost pool, which we find is inappropriate.

Mr. SIKORSKI. Well, that's a good deal. You get people to buy it, and you get it in through contributions from people who want to contribute to the university, and then you can get the taxpayers to fund it, pay for it as well through the indirect costs.

Mr. KUSSEROW. It would be a good deal for them.

I think in all fairness I should mention that all $985,000 was volunteered as a result of the work done by their own internal auditors, so that these are items that they declared themselves. We had a entrance conference with them, and then they presented that upon our entrance.

Mr. SIKORSKI. The last school on the list, the University of Southern California, $3,112,000. Was that volunteered?

Mr. KUSSEROW. Yes, sir. All of it was——

Mr. SIKORSKI. All of that $3 million, what kinds of things were there, and that's the last one?

Mr. KUSSEROW. They had things like the president's office, the student newspaper, university communications, the trustee's conferences, the presidential search and transition expenses, public relations, really their news service, the search committee fund, academic honors.

They had a wide variety of other things: dues and memberships for the university, student newspaper costs. There were just a wide variety of—telecommunications administration, supporting the Faculty Senate, just a wide variety of items like that. I can give you a complete listing, of course, to the committee.

Mr. SIKORSKI. Thank you for your help. Thank you, Mr. Chairman.

Mr. DINGELL. The Chair thanks the gentleman. The Chair notes there is a vote on the floor, the final passage of H.R. 2251.

I think in view of the fact that we're where we are, it would be well for us to recess at this time, and the Chair will then—we will then return at the end of 15 minutes and proceed with the business of the committee.

So we will stand in recess for a period of 15 minutes and then return to continue the business of the committee.

Mr. Moley and Mr. Kusserow and gentlemen, we thank you very much for your assistance to us. We look forward to further help in dealing with the problems that we confront today when we resume in approximately 15 minutes.

Gentlemen, we thank you for your assistance to this point.

[Brief recess.]

Mr. DINGELL. The subcommittee will come to order.

The Chair recognizes himself for questions.

Mr. Kusserow, Mr. Milt Socolar of the General Accounting Office testified, during the earlier hearings of this subcommittee on Stanford, that Stanford took advantage of every opening that presented itself in dealing with the Federal Government.

Now, based on what you have seen at a number of these schools now, do you believe that this is a pervasive attitude throughout the university community?

Mr. **Kusserow.** Yes, sir, I do think that is the pervasive attitude. I do not know if it is the university attitude, but certainly when they use, when they contract for services from accounting firms, that is certainly their feeling, that you should try to get as much in there as possible. They figure that is good advice, and I think that is what you heard from the public accounting firm that Stanford had used. They actually put that in the test, and they thought nothing wrong with that. They said yes, advise our clients, all the universities that are our clients to try to get as much as they can into the indirect costs. So I think it is pervasive.

Mr. **Dingell.** Did that include advice to double bill?

Mr. **Kusserow.** Well, they should not do that, no, sir.

Mr. **Dingell.** We had two cases of double-billing. One was the statue, in which they billed the Federal Government for a statue which had already been purchased for the school, I guess by the alumni, or other generous givers. The other was the shopping center, where depreciation, which I assume had been charged off against the Tax Code, was then subsequently charged also against the Federal Government.

Mr. **Kusserow.** That is totally inappropriate.

Mr. **Dingell.** It appears to be not only inappropriate, but possibly criminal.

Mr. **Kusserow.** If you could show that they did it with malice aforethought and criminal intent, yes, sir, it would be criminal.

The problem is, in those situations, they will evidence the fact that it was a bookkeeping error or mistake, that it was not intended, and when drawn to their attention, they merely withdraw it. Proving the guilty mind is the hard part in those kinds of situations.

Mr. **Dingell.** Mr. Kusserow, can you tell us why you think this situation has gotten this way?

Mr. **Kusserow.** I think we have gone down a road that really has turned this into a game.

There is a certain familiarity to this ring. In fact, I think back in some hearings you had in the Defense Department, where you had a similar situation, where you had contractors that would try to put as much as they could in charges to the Federal Government, and were shocked when they found that that was not right, and people were outraged when they found out about it, but they would say that is the way the game was being played.

I think in large measure, it goes back to my previous comments about there is almost a game-playing quality about this, where somehow, the scientist part of this whole process that goes out to secure research is set aside, and then you have accountant to accountant, and it is in this other world that is unconnected, really, to the scientist's side, that you have these kinds of games being played on paper, and I just do not think that is the best way to go about doing business.

Mr. **Dingell.** My old Daddy used to observe that a few public hangings would help situations, to a marked degree.

What he was saying was, I guess, that there is a certain deterrent in criminal prosecution. There also is a certain deterrent value in proper use of audits. I detect that neither criminal prosecutions nor audits have taken place in connection with these matters, so as a result it sort of became the view that there was no deterrent, either through the possibility of catching or the possibility of punishment, and so everybody said, "let the good times roll."

Is that an unfair characterization?

Mr. **Kusserow**. Well, I do not believe that you really have an opportunity very often to get a criminal case out of these situations. If you can show that there was an intent to put things inappropriately into the cost pools in order to get more funding from the Federal Government, then you might have a prosecution, but those are very rare.

As far as the underlying problem, the problem, I do not believe, is the number of auditors or accountants that you have working for the Government that are going after the problem so much as the rules under which they are operating are so convoluted and so wide open and subject to interpretation that it really permits people to interpret it in a way that they would feel most advantageous to their institution, and then you have to debate it.

So we have gotten down to where you are debating accounting principles, debating whether something is appropriate for this pool or not, and I think it is the looseness that we have detected.

I mean, when you think that we just had the announcement come out that said that you really cannot use liquor, and put that in the indirect cost pools, that meant, understand, there was nothing in A-21 that prohibited liquor from being charged in the indirect cost pools. So when they were putting them in there, we would say that is inappropriate, and they would say it was not, but we would argue them out of it. The fact it was even subject to an argument is extraordinary to me.

Mr. **Dingell**. Let us take a situation where the trustees donated their travel. The Government, in turn, was billed by the university for that.

Mr. **Kusserow**. Totally inappropriate. If you could show that, in doing that, there was an individual who was responsible for doing that, and he did it willfully and with the intent to defraud the Government, you could have a criminal prosecution.

Mr. **Dingell**. Now, years ago the amount of overhead that was allowed on these kinds of contracts was what? It was down as low as 20 percent, as I recall.

Mr. **Kusserow**. If you go way back, yes.

Mr. **Dingell**. When was that?

Mr. **Kusserow**. It goes back before my time, I can assure you of that. It goes way back, 20 years or more, that it was down that low.

Mr. **Dingell**. We have seen a steady progression towards higher and higher numbers. Every year it edges up a percentage point or two. As you pointed out in your statement, that is $43 million a year, for a 1-percentage-point increase.

I note that one university, Howard, has now proposed an indirect cost recovery rate of 155 percent; is that correct?

Mr. **Kusserow**. Correct.

Mr. **Dingell**. What has been done about that request?

Mr. **Kusserow**. I will defer to my colleagues here, because they are engaged in the indirect cost negotiations with them.

Mr. **Dingell**. Mr. Moley or Mr. Talesnik, do you want to make a comment on that?

Mr. Moley. Mr. Chairman, that was their percent of indirect costs which they proposed. That is certainly not the percentage we accepted. It would not be. I think there is clear indication that we have a track record of reducing substantially the indirect cost rates as they have been proposed to something far less, even given the ambiguity of the document with which we have to make our case, which is A-21.

Mr. Dingell. Well, the university asked an indirect cost rate of 155 percent. You indicate it has been negotiated down to 75 percent.

What was negotiated out of this, and why?

Mr. Moley. I would defer to my colleague in respect to the specific negotiation. I am not sure whether we are familiar with the actual negotiation process.

Mr. Dingell. Mr. Talesnik, do you want to comment on that, sir?

Mr. Talesnik. Mr. Chairman, I do not have the details of that. I can get it. I do not know the specifics of those specific adjustments.

There were quite a number of adjustments, obviously, to get from what the institution proposed down to the 75, or 78, I believe, is the actual number that was actually negotiated.

Mr. Dingell. Well, the rate started out at 155 percent. You cut it to 75 percent. You have cut it by more than half. Now, what was Howard trying to put into this overhead cost equation, and what was the Government refusing to allow?

Mr. Talesnik. Again, that relates to the details of that particular negotiation and I am not personally familiar with it.

Mr. Dingell. Mr. Kusserow, can you give us any guidance on this?

Mr. Kusserow. I am afraid I would have to go to the record as well, because I would be hesitant in going down the specific list of things that caused it to be reduced, without going back to the original papers. I think I could do an injustice to that process if I were just to take it off the top of my head.

[The following information was received:]

The indirect cost proposal from Howard University referred to in the Inspector General's testimony was approximately 145 percent, not 155 percent. The Department's indirect cost negotiator made a number of adjustments to reduce the rate to 75 percent. The major adjustments included rejection of a special study the university proposed to use to allocate its library costs; a change in the method used to allocate "Sponsored Projects Administration" costs which reduced the portion of these costs allocated to research programs; removal of some Sponsored Projects Administration costs from the indirect pool because they were not adequately supported; a change in the allocation of certain "Departmental Administration" costs which reduced the amount allocated to research programs; and reclassification of some Departmental Administration costs to another indirect cost pool which also reduced the amount allocated to research programs. The 75 percent rate was negotiated for fiscal year 1987. The university's current rate is 78 percent, which has been in effect since 1988.

Mr. Dingell. All right, now, Mr. Talesnik and Mr. Moley, we have a similar case at Harvard. Harvard proposed an indirect cost rate of 114 percent. It is my understanding that your office is unilaterally imposing a rate of 63.5 percent.

Now, can you explain to this committee how Harvard could have been asking for 50 percent more in indirect recovery than you believed they were entitled to?

Mr. MOLEY. Mr. Chairman, we have had, as my colleague will, I am sure shortly explain, some rather contentious negotiations with Harvard over a long period of time.

Once again, I would put it in the context of Circular A-21, sections (E), (F), and (G), specifically, which I would suggest to you are almost unintelligible to any normal person, which spell out what is allowable and allocable as indirect costs.

In fact, there is a flavor for it on page 8 of the Inspector General's testimony, which, even given his best intentions, I think it is very difficult to ascertain what could be charged is of reasonable benefit to any given university. As you know, we have not recovered, but disallowed substantial amounts from the proposed indirect cost rate at Harvard.

Gary, you may want to add to that.

Mr. TALESNIK. Yes. There are numerous adjustments that our negotiators made to the proposal that was submitted by Harvard Medical School. Because we could not reach a negotiated settlement, a unilateral notice, as we call it, was issued to Harvard Medical on April 26 that laid out a rate of 63.5.

Harvard has indicated that they will appeal that decision, and we do have an appeal process within the Department that they can avail themselves of.

There were a number of adjustments that our negotiators had made to the proposal of 104 percent. The 104 percent rate that was proposed by the school was based on actual costs for fiscal year 1989 of roughly 95, plus a projection for some additional costs that they expected to incur for fiscal year 1991, because we were dealing with trying to establish a rate for 1991, and perhaps subsequent years.

The adjustments that were made dealt mainly with how costs were allocated. We had some serious difficulty.

Mr. DINGELL. The mechanism for allocating the costs, as opposed to the categories of costs, or the definition of a cost; is that correct?

Mr. TALESNIK By and large, that is correct. So there are some major issues as to how those costs are allocated, what costs are included in the so-called allocation base, and that sort of thing, that resulted in a substantial reduction, at least in the opinion of our negotiators, from what the Harvard Medical School had proposed.

Mr. DINGELL. Now, Mr. Moley, your comments, I thought, made a great deal of sense, when you referred to the statement of Mr. Kusserow at page 8. I had underlined that earlier, since it piqued my interest.

Perhaps a little reading of what was said there would be of use here to us in our scrutiny.

Mr. Kusserow, you said this: "In our opinion, the current version of OMB Guidance (A-21) does not provide incentives to schools to minimize or contain costs allocated to Federal research projects. Basically, A-21 permits universities to charge expenses to Federal research when those expenses are allowable, allocable, and reasonable. Costs are considered reasonable." And you then say: "If the nature of the goods and the services acquired are applied and the amount involved therefor reflects the action that a prudent person would have taken under the circumstances prevailing at the time the decision to incur the costs was made, the subjective test of reasonableness provides great latitude to schools to include many items and services that might otherwise be excluded under more specific Federal Acquisition Regulations. The costs are allocable to a specific project if the goods or services are chargeable or as signable to such cost objectives in accordance with relative benefits received, or other equitable relationship."

That virtually says you can charge any dang thing to the Government you are minded to, does it not?

Mr. **Moley**. Mr. Chairman, I would suggest to you that it places not only a burden on those of us on this side of the table who are negotiating those indirect cost rates but places a burden on a university acting either in good or bad faith in respect to their negotiation, and I would like to further point out that we expect to have further interim steps announced as early as next week in this regard in terms of putting limitations on the administrative cost pools.

An attempt, as you may know, was made in the last administration, in 1986, which the Congress did not see fit to support at that time, but clearly I think we're all on the same side of this issue at this time.

Mr. **Dingell**. Your comments, I think, Mr. Moley, are very helpful and I commend you for them.

Now, Mr. Talesnik, the subcommittee held a hearing on Stanford in March where one of the major problems identified was a lack of Government oversight and audit. It is my understanding that you and HHS attempted to achieve cognizance from the Navy concerning Stanford. Is that correct?

Mr. **Talesnik**. Yes, sir.

Back in the late 1970's, we did make a proposal to the Office of Management and Budget to switch Stanford from the Defense Department to, in those days, HEW. Stanford, as I recall, objected to it rather strenuously, and the net result was that the university, as we all know, stayed where it was.

We have not made a similar pitch—since we were turned down then—along those lines in recent years.

Mr. **Dingell**. What you are telling us is that you felt that, at that time, the HHS should take over from the Navy the responsibility of administering the contracts and auditing the contracts with Stanford but that Stanford objected and that the Navy and the Defense Department supported that view, and as a result, the responsibility for supervising those particular contracts was not given to HHS. Is that correct?

Mr. **Talesnik**. That is correct, Mr. Chairman.

As a point of clarification, the cognizant agency is responsible for indirect cost negotiations, audits and the resolution of certain types of audit findings. Other grant and contract administrative responsibilities are handled by the individual Federal agencies that award grants and contracts to the institutions.

Mr. **Dingell**. OK.

Mr. **Moley**. Mr. Chairman?

Mr. **Dingell**. Yes, sir.

Mr. **Moley**. In respect to that same issue, the issue of indirect costs in respect to Stanford came to our attention last summer by virtue of an article that you and your staff may have seen in Science magazine, in the April 1990 edition.

As a result of that and subsequent inquiries we made in the Department of Health and Human Services, I sent a letter to the Comptroller of the Department of Defense on September 20 of last year indicating our concern in respect to this issue.

Although we may all be late coming to this issue in its most recent reincarnation, we have been concerned about this, even prior to your hearings, and as you know, we have been working with your staff in respect to this.

Mr. DINGELL. Thank you.

Now, Mr. Moley, you and Mr. Kusserow are the recipients of this question: On average, HHS has negotiated rates about 8 percent lower than Department of Defense. What would be the difference between the rates—what would justify the difference between DOD's rates and HHS's rates with regard to overhead and indirect costs?

Mr. MOLEY. Mr. Chairman, I could say that we do a better job and maybe we do, but in fairness, there may be some items which are not apples and apples in respect to the negotiations, and I would defer to the next panel in respect to that.

We do think, however, we do a very tough job, given the ambiguity that exists in A-21, as it currently exists, given the fact that things like entertainment and alcoholic beverages, offices of the university housing, et cetera, were, in part, allowable until the recent April 22 notice from OMB.

Mr. DINGELL. Now, it is interesting for me to note that a number of schools have requested to be shifted from HHS supervision to DOD but that no schools have requested to be shifted from DOD to HHS.

Now, are these two phenomena, the 8-percent differential in favor of DOD recipients and the fact that everybody seems to want to get out from under your supervision, in any way related?

Mr. KUSSEROW. The evidence would seem to suggest so.

Mr. DINGELL. Mr. Kusserow, I have asked questions of both you and Mr. Moley. Do you want to have a try at answering the question, if you please?

Mr. KUSSEROW. Well, in all due fairness, there probably are some differences in the environment, but I think what we can talk about is what we know best, and the methodology that our Department has employed in working in this area may be a little bit different than the Defense Department.

By and large, the type of science that we sponsor is different than the kind of science that Defense sponsors. Defense sponsors applied science. In other words, they are looking for something in return for the money that is invested in the research, something that will forward the Defense mission. So, in that respect, it is really not too much unlike a procurement.

In our case, there is nothing like a procurement involved, because we are investing in basic research, very non-directed. We are not telling anybody to do anything. We are not expecting them to come back with anything. We are just investing in pure science that will hopefully, in the aggregate, advance biomedical research.

As such, the approach that we have taken has not been looking at it as a procurement or as a contract but really trying to look at it on the front-end side of the system.

We have developed our strategies over the years to work very, very close with the Division of Cost Allocation in Mr. Moley's office, with our auditors, whereby we could put the heavy part of our commitment of resources on the front-end side to prevent inappropriate expenditures, and therefore, I think we probably put an awful lot on trying to get the indirect cost rates down through the negotiation process on the front-end, rather than coming in after the fact. Perhaps that might also account for some of the difference.

Mr. DINGELL. I find one very interesting thing, Mr. Kusserow, to which you might direct your attention, and that is Johns Hopkins University. Johns Hopkins University had a rate with the Department of Defense of about 73 percent, as I gather, in overhead or indirect costs, and 65 percent with HHS. Is that right?

Mr. KUSSEROW. Johns Hopkins is a very unusual situation, in fact, because of the division of responsibility. Applied Physics Lab, which represents, I would imagine, around $400 million of Federal grant money comes from the Defense Department, and then the other side is about $100 million with HHS, primarily biomedical research.

That differential does exist. So, you do have an 8-point spread there between that portion of Johns Hopkins which is HHS from that which is the cognizant responsibility of the Defense Department.

Mr. DINGELL. I heard they have made some considerable effort to get shifted from your administration to that of the Department of Defense. Is that right?

Mr. KUSSEROW. I think that is an understatement.

Mr. DINGELL. As a matter of fact, they succeeded, and then they did not succeed. Would you tell us about that story? I think that is interesting.

Mr. KUSSEROW. The Lord in Washington moves in mysterious ways. I will say that, at the very end of the last administration, Johns Hopkins was reassigned, the part that we had cognizance for, to the Defense Department.

Mr. DINGELL. Which would have raised their entirety from 65 to 73 percent.

Mr. KUSSEROW. It could very well have been negotiated to the same rate as what they had for the Defense.

Mr. DINGELL. That all came apart.

Mr. KUSSEROW. Yes. Again, Washington moves in mysterious ways. Just shortly before the transition was completed, it got moved back to HHS.

Mr. DINGELL. They lost the 8 percent.

Mr. KUSSEROW. It is back to where it was before, and it has not moved since, and after this hearing, I doubt that it will.

Mr. DINGELL. Well, we might be asking you a few more questions about this one, because my interest has been piqued, and I would like to find out how the good Lord helps the Government of the United States. Maybe we can encourage Him to assist us to a greater degree. Heaven knows we need it.

The Chair is going to recognize my good friend from Georgia for questions.

Mr. ROWLAND. Thank you, Mr. Chairman.

Mr. Kusserow, you referred to the large number of internal control issues that were found by auditors in recent years. Can you give some examples of the types of issues that were involved?

Mr. **Kusserow**. If I may, could I defer that to the audit director? He is probably much better qualified to respond to that.

Mr. **Roslewicz**. I am sorry. Would you repeat the question?

Mr. **Rowland**. Well, in the testimony that Mr. Kusserow gave, he referred to the large number of internal control issues that were found by auditors in recent years, and we just wondered if you could give us some examples of those issues.

Mr. **Roslewicz**. OK. In our report, we had two types of audits that are done. We have some that are done in-house by ourselves, but we also have responsibility, under Circular A-21, to review single audits that are done by non-Federal auditors at colleges and universities, as well.

So, there are two different types of audits being done. One we do ourselves. The second one, we do a review to make sure they are in compliance with Government standards.

Now, for the internal control type findings in this report, we indicate that there are about 2,196 of them, and they have to do with reporting, the forms that are required to be sent on a regular basis, quarterly reports, yearly reports. These were not being done. They were not being prepared properly.

Some of the accounting systems were not in the order they should be, and there were some questions with regard to cash management, with some property procurement. All of these things had to do with the internal control systems of the colleges and universities.

Mr. **Rowland**. At which universities did you find these examples? Can you tell us that?

Mr. **Roslewicz**. I do not have the list of the universities here. We are talking about some 2,000 audits that were done. I could certainly provide that for the committee.

Mr. **Rowland**. That would be fine if you did that. We would appreciate it.

Now, you also said there were some poor or weak internal controls that could have resulted in errors, wasteful practices, or fraud. Can you give us an example of where fraud might have been found, and what steps did the Agency take to really pursue this?

Mr. **Kusserow**. We had some examples that Mr. Dingell had alluded to where we would find, for example, where you may have had a double charging, and when you went in and you examined the internal control system, you would find that the weaknesses within internal control made it possible for that to occur. Then the question naturally comes to the forefront of your mind: Was that deliberate or was it inadvertent?

The fact is, whenever we do find those kind of situations that are questionable, we go back to the systems themselves to see whether it could reasonably be expected that it would arise from a failure of the internal control systems, or whether there was a steering of it, that the internal control systems would have caught it were it not for the fact that somebody superceded the systems.

So whenever you find that there's a breakdown, something where you do find a double billing or an inappropriate billing, you want to go back to the system itself and say, is it as a result of weak internal controls, or is it a result of malice aforethought.

Mr. **Rowland**. Did you find any examples of what you might have thought to be fraud?

Mr. **Kusserow**. Almost in every single instance, we have found that where you have had inappropriate things put into the indirect cost pools—I mean grossly inappropriate—that when you went back and examined the internal control system, it was because it was sloppy, or it was poorly built or poorly structured, or there was a weakness there that gave rise to it, rather than criminality.

Mr. **Rowland**. You had testified earlier that you had not found anything that you felt was of a criminal nature.

Mr. **Kusserow**. The criminal cases that we have had have almost always been on the direct side, where you have a—where it's easy to trace the Federal dollars.

As we had pointed out in our testimony, in the indirect cost pools, there is the Federal identity sort of mixed in with all the rest of it, and it's only a portion of it that goes to the Federal Government. But that's not the case when you have the actual grant itself on the direct research side.

We have had a number of cases that we have prosecuted whereby there has been an embezzlement of the grant or a misapplication of the grant. In those cases, you're able to apply the criminal statutes to it. But on the indirect side, on the indirect cost pool side, the problem by and large is with the internal control systems.

Mr. **Rowland**. Let me ask you a question about the schools that are under your cognizance and some States that either have in the past or are considering implementing a State furlough system. Would you tell me what a State furlough system is?

Mr. **Roslewicz**. OK. What's happening now is several of the States—primarily the Eastern Coast—we were just beginning to get into this, Mr. Chairman—what's happening, for example, in the State of Massachusetts, Rhode Island and Maine, because of their budget problems in the States, they are beginning to furlough some of their State employees for perhaps a year, for 1 or 2 days every month or so, whatever the case may be. They haven't resolved this yet. They have three options that they're considering, for example, in the State of Massachusetts.

Now, this would affect not only the indirect cost at the State universities, but it could affect all of our Health and Human Services programs as well. If they were to furlough an individual, and he were to take days without pay, you'd have to make sure there are controls in place to prevent the charges to the Federal programs.

So we're just beginning to get into this area, to look at what these States are going to be doing when they start furloughing employees, especially those who are assigned to program areas that have Federal dollars coming into it.

Mr. **Rowland**. Let me ask you this——

Mr. **Dingell**. Will the gentleman yield, because I think I can be of assistance to the gentleman.

Mr. **Rowland**. I yield to the chairman.

Mr. **Dingell**. The way the State furlough would have worked in Massachusetts is this, and I want you to check me. The State would decree that on a given day, there would be no State activities, and all the employees were on a payless furlough. Is that right?

Mr. **Kusserow**. Yes, sir.

Mr. **Dingell**. And the money that would have been paid to those people would then be allocated across the board to expenses for the rest of that calendar year or fiscal year for the State. Is that right?

Mr. **Kusserow**. That's correct.

Mr. **Dingell**. So in the case of grants to a State institution—for example, a hospital up there, Massachusetts General—or to a State university in Massachusetts, or moneys which would have been made available for Medicare or Medicaid from the Federal Government, or for other Federal research, or for Federal programs, would simply not be spent that day, but would be allocated then across the rest of the fiscal calendar year to the State.

This would have the practical effect—I want the gentleman to listen with care to this—this would have the practical effect of shifting Federal grant moneys for research and Federal moneys for other kinds of State Federal cooperative programs to the State treasury without having them spent for the purposes for which they were allocated to the State. Is that correct?

Mr. **Kusserow**. That's absolutely correct. It really goes beyond A-21. It also goes into A-87 principles under OMB guidance. So it really would be a mechanism by which you could shift the burden to the Federal Government inappropriately.

Mr. **Dingell**. Essentially, and I apologize for intruding on the gentleman's time, but it would essentially permit, then, the State, to use this devise of payless paydays for the State employees to get money from the Federal Government from programs like research programs, programs for other kinds of Federal purposes which would otherwise have been expended.

Now, I gather that that process has been halted in the State of Massachusetts. Am I correct?

Mr. **Kusserow**. Yes. Of course, as you are pointing out, that would have the effect not only on money granted for research institutions, but any other Federal grant programs that would exist with the State as well.

Mr. **Dingell**. For health, or roads, or highways——

Mr. **Kusserow**. Anything.

Mr. **Dingell**. Or education, or air safety, or food and drug, or air pollution, or water pollution, or whatever the program might happen to have been.

Mr. **Kusserow**. That's quite correct.

Mr. **Roslewicz**. If I might add to that, too, the State of Massachusetts has assured us they will not be charging any of this to the Federal research programs.

Mr. **Dingell**. How about other programs?

Mr. **Roslewicz**. Well, we're in three schools, you know, checking up on that. With our auditing nature, we're going to go in there and check to make sure this is not happening.

Mr. **Dingell**. Now, has the State of New York had similar endeavors in the last couple years?

Mr. **Roslewicz**. No, New York has not done that yet.

Mr. **Dingell**. Has any other State?

Mr. **Kusserow**. Rhode Island and Maine have also been moving in that direction.

Mr. **Dingell**. I beg your pardon?

Mr. **Kusserow**. Rhode Island and Maine have been moving in that direction as well.

Mr. **Dingell**. I see. Mr. Moley, is there a Department policy on this particular matter that's been so well pointed out by my good friend from Georgia?

Mr. **Moley**. We have been cooperating with the Inspector General. It is not our intention, Mr. Chairman, to permit moneys earmarked for one program to show up in someone else's general revenue fund.

Mr. **Dingell**. Thank you.

Mr. **Kusserow**. If I could add one thing, Mr. Chairman. I don't mean to suggest that the only places that this could pop out—there are a lot of other States that are in the wings looking to see whether they should consider moving in this direction. Still in New England, you have Connecticut that has it under consideration, but in other parts of the country, you have Pennsylvania, and the District of Columbia has even been looking in that direction, and you have Florida. I did want to have this, because Georgia has been considering that, as well as Mississippi, Michigan and Minnesota.

Mr. **Dingell**. I happen to think that Michigan is looking at it with covetous eyes, too.

I think the Chair is going to direct the staff to prepare a letter to the Office of Management and Budget with regard to this. We have sent you one letter with regard to Federal research programs.

I am troubled that this may escape so that we're finding almost every kind of program, from inoculations, to road construction, to food and drug, and air and water pollution, environmental matters, everything is subject to this kind of adroit budget bookkeeping to enable the State to enrich itself at the expense of Federal programs which are not effectively being carried out.

Mr. **Kusserow**. Well, then, I think we probably should make a confession here and now before you, Mr. Chairman. That is that we do not have a monopoly on all the best Government accountants and auditors, that some of the best are really located in the States, and when States get stressed in their own budget deficit problems, they get very creative as to how to protect their own treasuries. Unfortunately, it's at the expense of the Federal taxpayer.

Mr. **Dingell**. Well, we will try and harness that creativity for the benefit of all.

Mr. **Kusserow**. Thank you.

Mr. **Dingell**. The Chair thanks the gentleman.

Mr. **Rowland**. Do you yield back, Mr. Chairman?

Mr. **Dingell**. I thank the gentleman.

Mr. **Rowland**. Well, you certainly explored an area that I was thinking about and, in fact, clarified some of the thoughts that I had, because I was wondering if, for example, a researcher at a university would be placed on a furlough program, and then the money would still continue to come in from the Government, although the researcher was being paid by those funds, the school would still be collecting the funds. But I believe you stated that the State would be collecting that money.

Mr. **Kusserow**. Where we've been finding that has been sub-entities of the States. So when you find that it's a school, most often it's going to be a sub-entity of the State. It'll be a State university or a State college.

Mr. **Rowland**. Well, it's still one of those nebulous things that you can't really get your hands on and say that there was really intent here to commit fraud.

Mr. **Kusserow**. Well, I think we can say in this case that there was a very definite intent behind this to shift the burden to the Federal Government. But the problem is, is that that kind of an intent is not prosecutable under Federal law. If that were the case, we would have an awful lot of prosecutions among State officials.

Mr. **Rowland**. Well, let me just be sure I understand what you're doing now with Federal research contracts to be sure that this kind of abuse doesn't take place. Would you state that again for me, just briefly?

Mr. **Kusserow**. What we will be doing is first of all, we're defining the scope of this kind of activity. We're not limiting it just to the university arena; we're looking at it across the entire Federal Government as it relates to granting activities with the States to ensure, (a) what is the level of activity, and then, (b) how it is that we can constrain it and control it and eliminate that kind of an abuse.

So we'll be working in that area. We will be working with the administration to block the abuses. If it turns out that, administratively, we don't have the mechanisms available, which I think, in this case, we do, then we would probably come back to the Congress and ask them to assist us in closing a loophole.

Mr. **Rowland**. You mentioned in your testimony that the schools who have performed self-evaluations and withdrawn accounts all did so after being identified as high priority targets for your auditors. Can you name any schools who have voluntarily withdrawn or decided to repay funds who have not been singled out by your Agency?

Mr. **Kusserow**. No, sir.

Mr. **Rowland**. Mr. Moley, one of the key concerns at the hearing in March was the willingness of Stanford University to either waive or accept significantly reduced overhead payments for research sponsored by foreign governments including the government of Japan and private corporations, for example Weight Watchers.

If the Government were to demand equal treatment, that is, not pay overhead or paying significantly less, what impact would that have on indirect cost reimbursement?

Mr. **Moley**. Congressman Rowland, this is the whole issue of who should be paying what indirect cost rate. As you have pointed out, there are institutions and countries for that matter paying a lesser indirect cost rate than we are.

I would suggest to you however that some of these overhead costs are going to have to be paid for somehow or some way. The Inspector General has indicated as one of those issues to be dealt with in a longer term view is should there be some prohibition against someone getting a lesser indirect cost rate than is charged to the Federal Government.

I guess one concern that might readily become apparent is if you were offered a small amount of money by Weight Watchers or General Motors, or even a foreign country in comparison to how much money the university might receive from the Federal Government the university might in fact simply not take that money in order to maintain their current indirect higher cost rate from the Federal Government.

Having said that, as I said, I think we'll be out as early as next week with some ideas revolving around a possible cap on those portions of the indirect cost rates about which we have the most concerns which have been discussed today—the administrative cost pools.

We think that some parts of the proposal have already been floated on the Hill and as I said they have been discussed with OMB and others will be coming out from the Department and from the administration as early as next week, which might obviate the need for some of this discussion about who gets what indirect cost rate compared to the Federal Government.

Mr. ROWLAND. Well, you know, one really wonders why the U.S. Government should finance operations of universities but not the government of Japan when the government of Japan is more able and in a better financial position than the U.S. Government is.

Would you—would that cause you some thought?

Mr. MOLEY. It causes me concern and thought and I just want to make sure that whatever we do, and I think that it is imperative that whatever action the Congress takes in this matter, is done with the idea that there are unintended consequences out there.

We do not want to place ourselves in a situation where funding which would be coming to the United States is otherwise diverted elsewhere and has, as I said, unintended consequences, but we are absolutely concerned about the apparent inequity in the Federal Government paying the American taxpayer paying, a higher indirect cost rate than is done for research grants to the university from Japan or elsewhere.

Mr. KUSSEROW. If I may, could I add to that?

Mr. DINGELL. Would the gentleman yield?

Mr. ROWLAND. Yes.

Mr. DINGELL. Mr. Moley and Mr. Kusserow and Mr. Talesnik, perhaps, gentlemen, you can assist us in telling us what was the differential between overhead charges assessed against Federal Government research programs and what was the overhead assessed against for example research done for the government of Japan, corporate entities, or other private or governmental institutions? What was the magnitude of the differential?

Mr. MOLEY. Mr. Chairman, in preparation for this hearing, I had asked our staff and quite frankly anybody I could find to come up with incidences like this.

I am not sure that we on the negotiating end have those incidences. We keep hearing about this anecdotally. Dick may have more specific information.

Mr. KUSSEROW. We do, but if I may preface it, Mr. Chairman, with this observation. Once again we go back to books and records and how you characterize them.

In some ways it is hard to compare the indirect cost rates for, let's say, an industry grant or a foundation grant with that of the U.S. Government when we are supporting research because they characterize what is direct and indirect differently and again this goes back to my point about until you can get some sort of standardized accounting and agree to rules, you will always have this confusion.

We do know and as we have looked around the universe, especially at some of the schools that we're in now, that a lot of the foundations like the National or American Cancer Association, they get a lower rate. They get a 25 percent overhead rate, indirect cost rate.

The problem is what precisely is in that indirect cost rate and how do you measure that against what is in a Federal Government indirect cost rate? They are different. They are not exactly the same.

We found also for example that at some schools they won't even charge an overhead rate to certain types of nonprofit grantors for research.

Some may—we found for example that at one major university they had the American Heart Association who receives an indirect cost rate of 10 percent, so you do have a lot of variants, an enormous number of variants where you go actually from zero overhead, indirect cost overhead, unallocated overhead, to something that would approach what the Federal Government pays.

If you wanted a rule of thumb, the rule of thumb would be that the indirect cost rates for other than the Federal Government are generally lower.

Mr. **Dingell.** What would justify having a lower rate for research done on campus or rather for other entities in the Federal Government?

Mr. **Kusserow.** Well, there are a lot of different variables.

The first variable I would restate is the fact that, how you define indirect cost is different with those who are non-Federal entities who are granting money than it is with the Federal Government so you are going to have differences as a result of that.

In addition to that, you'll have the point that Mr. Moley had made about if you have a very small grant coming from a charitable organization that has very limited resources available, you might just say, well, you know, we're not going to charge you an overhead rate.

Mr. **Dingell.** Let's recognize that and agree to that.

Let's take the government of Japan. What would justify a differential in overhead charges to the government of Japan as opposed to overhead charges to the Federal Government?

Mr. **Kusserow.** I can't say.

Mr. **Dingell.** Obviously there is something that must create a real visible preference in the mind of the university in favor of research done for the government of Japan as opposed to the government of the United States.

What would that be?

Mr. **Kusserow.** I couldn't say. We have of course since this issue was raised in your hearing with Stanford, we like Mr. Moley's staff have been looking in our schools to see if we could find evidence of particularly foreign governments. Thus far we haven't got enough to where I could feel comfortable to speak to the issue.

Mr. **Dingell**. You have not found any?

Mr. **Kusserow**. No.

Mr. **Dingell**. None?

Mr. **Kusserow**. Not yet, but I'm not saying that we are giving up looking.

We are looking but we haven't seen it as yet.

Mr. **Dingell**. We will expect you to look with considerable vigor. I thank the gentleman for yielding to me.

Mr. **Rowland**. I have no further questions, Mr. Chairman.

Mr. **Dingell**. Mr. Kusserow, in your report dated May 8, you highlight a number of examples of poor internal controls and findings of unallowable and allocable charges to the Federal Government.

You cited, for example, residential events such as receptions, Commencement, and pre-football game activities, travel for the band, and legal fees involving the NCAA, collection and legal costs associated with bad debts, preparation expenses for the Olympics.

Can you identify the institution referred to and explain the examples in greater details?

Mr. **Kusserow**. Yes, sir.

Can I submit that to you Mr. Chairman? I'm not sure that I would give you the right school. I'm beginning to get confused with schools now, and I'm fearful that I may say——

Mr. **Dingell**. OK. If you will then identify that for the subcommittee.

Mr. **Kusserow**. I will. Yes, sir.

Mr. **Dingell**. Could you, though, please explain the examples in slightly greater detail. These have peaked my interest.

Mr. **Kusserow**. I believe you're probably referring to the kinds of things that we had on page 12 and 13 of our report, where we talk about, like for example, receptions and catered dinners, including rental of tents and liquor and things of that sort, and walk through that?

Is that what you're looking for, Mr. Chairman?

Mr. **Dingell**. You can address it that way, if you like.

Mr. **Kusserow**. If you go to page 12 of the testimony, we cite the kinds of things that we have encountered that are fairly common, and among them, of course, are the idea of reception and catered dinners, including rental of tents, liquor, the whole balloons, valet parking, and things that relate to that. I had looked at them one way with you, but let me just see if I can kind of crosswalk it now.

We did find those kinds of things at such places like the University of Texas Southwest Medical Center or Johns Hopkins, the University of Pennsylvania, the University of Pittsburgh, Duke and Emory to kind of give you an idea just in the finite list that we were working from, just how common that kind of an expense problem is.

With regards to the legal expenses for lawsuits that really are—lawsuits that really are unrelated to research and to the grants, we found those kinds of problems, as I mentioned earlier, at Dartmouth and at the University of Pittsburgh and the University of Southern California.

With regards to things like the travel kind of abuse situation, that really is travel that is unrelated to any research effort. I had already mentioned the one thing about the president's wife for trips to the Grand Cayman Islands. That relates back to Pittsburgh.

But those kinds of things also have popped up elsewhere. We have it at Hopkins; we have it at Yale; we have it at Dartmouth. There's a number of other schools on the list, again to indicate that that is a common type of abuse that we have encountered.

With regards to that special merchandise item that we have in there and the kind of records which turn out to be liquor, I mean, I guess they suspected that if they just said "liquor" that it wouldn't pass muster, but maybe if they put "special merchandise" down, it might have slipped past the accountants. That was the University of Pittsburgh.

On the private club membership, I had mentioned, as we went down the list of the schools, that that was a fairly common thing, and indeed it was. We have that, if you go back on the list on page 14, you'll see that most of the schools are in that category, that have sponsored club membership in golf clubs, membership and charged it to the indirect cost pool portion which goes to the Federal Government. Johns Hopkins has done that, the University of Pennsylvania, the University of Pittsburgh, Duke, Emory, Washington University at St. Louis, the University of Southern California. So a majority of the schools that we're currently looking at have that as a problem.

The example I had given on the engraved decanters—that's from Neiman-Marcus—that is the University of Texas Southwest Medical School, as I had mentioned earlier. On the sculpture that we had talked about earlier, that was Washington University at St. Louis.

With regards to the mailings and other expenses that relate to alumni activities, that is something again that's fairly common. We found that so far in the list that appears on page 14. We found that at Yale. We found it at Penn. We found it at the University of Pittsburgh and Emory.

Things like the president's house, the flowers, the chauffeur, the travel, gifts, cleaning supplies, and other miscellaneous things, those are very, very common. Most of the schools which I have gone through on page 14 have those kinds of problems to one degree or another.

So I think by bulleting it out, the point that I would make is that we're not talking about isolated types of problems where there may have been an inadvertence on somebody's part, or it is not common; it is an aberration which is very unusual.

No, that's not the case at all. We do find that these things tend to be fairly common types of problems that we encounter.

Mr. DINGELL. Now you mentioned in your report, and other members have inquired of it, you mentioned a weakness in a college department's—or rather in a college purchasing department's function, which allowed an employee to establish a fictitious company and embezzle over $400,000 from federally-sponsored research projects. Was that money which was taken from overhead accounts, or was that taken——

Mr. **Kusserow**. That came out of—not of the indirect, that came out of the direct.

Mr. **Dingell**. It came out of direct.

Mr. **Kusserow**. And that had Federal identity all the way through the whole thing. That was the one I mentioned at the University of California at San Francisco, wherein the individual was convicted, and the money was recovered to the Government.

Mr. **Dingell**. The money was recovered?

Mr. **Kusserow**. Yes, sir.

Mr. **Dingell**. That indicates very, very bad auditing, very, very bad accounting, very, very bad property and financial management, does it not?

Mr. **Kusserow**. It absolutely would, except for one thing, Mr. Chairman, and that is, the internal auditors at the University of California at San Francisco were the ones that found it and reported it. So in this case, I would give them a kudo for that, because they did find it. They did report it, and they did permit us to move ahead with resolving the issue without—with all of the support of the university behind it. So they were very supportive in that case.

Mr. **Dingell**. Very good. Now one of the concerns that this committee had earlier was the inadequacy of the utility study which had taken place.

According to your report, HHS has found, and I quote now, "significant deficiencies", close quote, at one of its universities. The report states that the Office of the Inspector General has found an inordinate number of exceptions relating to the accuracy of the data collected and determined that the proposed energy costs applicable to research were significantly overstated.

Now which university was this? Would you rather give us——

Mr. **Kusserow**. Do I have to answer that, because I think it was my alma mater.

Can I submit that for the record, Mr. Chairman?

Mr. **Dingell**. We are inquiring—we are inquiring, amongst other things, about the University of Michigan. I see why we—I see no reason why we——

Mr. **Kusserow**. I believe it was my alma mater. I believe it was UCLA. But to be absolutely certain, I'd like to research that out independently and make sure and document that that's exactly the right school.

I had hoped that I would not have to mention that school during the course of this hearing, and I'm somewhat flustered by the fact that it somehow has come out.

Mr. **Dingell**. Now tell me about, how was the allocation procedure on this matter rectified?

Mr. **Kusserow**. It was done—if we're talking about the right situation, it was done—it was done through the negotiation—cost negotiation process performed by Mr. Talesnik's staff.

Mr. **Dingell**. Mr. Moley, did you want to make a comment?

Mr. **Moley**. Just that I noted in my opening statement, Mr. Chairman, that one of the things, in order to improve our negotiating position is, that we are, in fact, now contracting for some specialized consulting services, one of which is for engineers to help us in evaluating the utility studies that compose part of the negotiating process, and Mr. Talesnik may want to speak to that as well.

Mr. **Talesnik**. Yes, Mr. Chairman. These utilities studies are done primarily by engineers. They basically go out and try to determine the amount of energy usage by different kinds of space within an institution.

Sometimes they're done well, and sometimes they're not done so well. We do find discrepancies. We do find areas that we question, either in the negotiation process or, as Mr. Kusserow mentioned, in the audit.

But one of the problems we've had in evaluating those kinds of studies is we do need some specialized technical assistance, and that's why we have decided to try to do something along those lines through contracts.

Mr. **Dingell**. You mentioned that the study was flawed. Could you gentlemen give us some assistance as to the character of the flaws and the loss or detriment that was suffered by the Federal Government as a result of this?

Mr. **Kusserow**. Yes, but I think if we could, we'd like to supply that for the subcommittee.

Mr. **Dingell**. Very well.

Mr. **Kusserow** [continuing]. To give you the proper detail.

Mr. **Dingell**. Very well.

Well, gentlemen, we have kept you a long time. You have been of enormous assistance to the committee. We believe that our inquiry has been carried forward much better because of your invaluable aid and help to us, and I want to express to you, Mr. Kusserow and Mr. Moley and your associates, the thanks of the committee, not only for your presence here, but for your invaluable assistance to us in connection with the audits now ongoing, and we look forward to further successes in your undertakings, as we know we will see, and I'm sure that your efforts will spark continued generosity on the part of the colleges and universities of the United States in returning moneys to their Government.

Gentlemen, you depart with the thanks and the appreciation of the committee.

Mr. **Kusserow**. Thank you, Mr. Chairman.

Mr. **Moley**. Thank you, Mr. Chairman.

Mr. **Dingell**. The Chair announces that our next panel will be a panel composed of Rear Admiral William C. Miller, Chief of Naval Research, Office of Naval Research, and Mr. Fred C. Newton, Deputy Director, Defense Contract Audit Agency.

Gentlemen, we thank you also for being with us here today.

The Chair notes that in our earlier hearings your assistance to the committee was very significant, and we very much appreciate your earlier help and your continuing assistance to the committee in this very difficult matter.

So Admiral Miller and Mr. Newton we want to express our particular thanks to you. We note that you have been conducting your affairs with a great deal of vigor and energy for which we commend you.

Admiral and Mr. Newton, having been before us earlier, you are aware of the practices of the committee. It is, of course, as you know, the practice of the committee that all witnesses are properly sworn.

For your information, copies of the rules of the committee, the subcommittee, and the House are there at the witness table to assist you.

The Chair inquires first: Do you gentlemen have any objection to testifying under oath?

Admiral **Miller**. No, sir, I do not.

Mr. **Newton**. No.

Mr. **Dingell**. Gentlemen, the Chair inquires, since you are testifying under oath, it is your right to be advised by counsel during your appearance here. Is it your wish, either of you gentlemen, that you should be advised by counsel during your appearance?

Admiral **Miller**. No, sir.

Mr. **Newton**. No, sir.

Mr. **Dingell**. Very well, then, gentlemen, if you have no objection to testifying under oath, if you will please rise and raise your right hand.

[Witnesses sworn.]

Mr. **Dingell**. Gentlemen, the committee thanks you for your assistance to us. You may consider yourselves under oath and recognized for such statement as you choose to give.

TESTIMONY OF REAR ADM. WILLIAM C. MILLER, CHIEF, OFFICE OF NAVAL RESEARCH, U.S. NAVY; AND FRED J. NEWTON, DEPUTY DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

Admiral **Miller**. Thank you, Mr. Chairman. With the Chair's permission, I would like to submit my formal, prepared remarks for the record and summarize them briefly for you here.

Mr. **Dingell**. Without objection, that will be done. You are recognized for such summary.

Admiral **Miller**. Mr. Chairman and members of the committee, I appreciate this opportunity to testify today and to update you on the status of overhead negotiations at Stanford University. I will also briefly summarize some of the actions the Department has taken to improve administration of federally sponsored research at other DOD cognizant universities.

First, with regard to overhead rate negotiations between the Government and Stanford, on April 9 of this year, following extensive review and analysis, the Government notified Stanford that all Memoranda of Understanding existing between the university and the Government, except the one covering tuition remission, had been cancelled, effective September 1, 1990, the beginning of Stanford's fiscal year.

This action was based on the best information we had available at that time, and upon the recommendations of DCAA, the Department of Health and Human Services, the Government Accounting Office, and the Navy's own Special University Team at Stanford. The single MOU remaining with Stanford, on tuition remission, has been retained pending Office of Management and Budget review of Government policy in this area as part of a comprehensive study of regulations governing indirect costs charged to the Government by the universities; that is, Circular A-21.

From April 9 to April 25, Stanford and the Government continued to negotiate the university's fiscal year 1991 indirect cost rates, but were unable to reach agreement. Therefore, because no additional substantive information was expected to be available in the foreseeable future, the Government issued a unilateral rate determination to Stanford that established a provisional rate of 55.5 percent, also backdated to September 1, 1990, their current fiscal year.

After audit of Stanford's final indirect cost rates, following the end of their fiscal year, ONR and Stanford will negotiate a final rate for this fiscal year. Any over or underpayments during that year will be reflected in subsequent year indirect cost rate negotiations.

As a result of related concerns about inappropriate indirect costs having been charged to the Government more broadly, the Navy has initiated several actions to provide greater visibility into certain elements of university indirect costs and to better assess the potential risk of encountering such practices at DOD cognizant universities other than Stanford.

First, ONR and DCAA are working together on a study of all Memoranda of Understanding at all DOD cognizant universities. This study is specifically designed to determine whether these MOU's are consistent with Federal regulations, whether they provided for an appropriate method of cost recovery, and whether they adequately protect the Government's interests.

At a minimum, the study will determine which MOU's are currently active and legally binding—if you will recall, that was a question we had at Stanford—and obtain DCAA audits and comments on all active MOU's. We also intend to negotiate revisions to each active MOU as required to resolve any issues raised by DCAA, and to ensure that each MOU includes an expiration date, rather than being left open ended.

Audits have now been completed by DCAA at 19 of the 20 DOD cognizant institutions at which MOU's are outstanding. We expect that the audit of the 20th, the California Institute of Technology or Cal Tech will be completed by the end of this month. All these institutions have been advised in writing that their currently active MOU's will either be discontinued or renegotiated by the close of the current fiscal year. We in the DOD plan to start fiscal year 1992 with a clean slate.

Second, ONR has prepared a new comprehensive practices and procedures manual—new policy if you will—governing indirect cost negotiations and MOU's, with an emphasis on ensuring uniformity and consistency in the treatment of indirect costs. This new guidance is now in distribution to all ONR university business affairs representatives. Any new MOU's to be negotiated will be reviewed and approved under these more rigorous procedures.

Third, in early April of this year, I sent personal letters to the president of every DOD cognizant institution, asking that each of them take a personal interest in reviewing their internal controls and ensuring that procedures are in place to guarantee proper indirect cost charges for federally sponsored research.

I also enclosed with each of these letters, a copy of GAO's testimony before your committee, sir, on March 13, as a guide to these universities for the types of costs that they ought to look for.

Mr. Chairman, I believe that we now see that the universities are beginning to take a long, hard look at their accounting, audit and internal control procedures. They are reviewing their screening processes to ensure equitable treatment of indirect cost allocations, and, more importantly, they are withdrawing not only unallowable costs; that is, those specifically disallowed, but also other costs that may be technically allowable, but are now perceived as inappropriate charges to the Government in support of Federal research.

For example, I understand that MIT has withdrawn costs for official functions, dinners, dinner meetings and receptions at the president's house for the period fiscal year 1986 through fiscal year 1990, and other expenses that they have since deemed to be inappropriate. Similarly, Cornell has withdrawn all costs associated with their President's household expenses and maintenance costs, as well as meeting costs that may have been inappropriately included.

Cal Tech and Columbia have withdrawn like charges. I anticipate more charge withdrawals in the months to come, as all of the Nation's universities review their indirect cost records and reevaluate their earlier interpretations of Federal guidelines.

We are now working with DCAA to establish procedures for returning these moneys to the Treasury, including direct refunds for any billed costs that are found to be blatantly unallowable.

Since I testified last before this committee, OMB has initiated a major review of Circular A-21, including tougher guidelines on both indirect cost reimbursements and internal cost allocation controls. I applaud their proposal. The Navy and DOD believe it will contribute significantly to clarifying the question of which indirect costs may be charged to the Government. I would add, sir, that both Mr. Newton and myself, as well as Mr. Moley and Mr. Kusserow, have been participating in the studies with OMB.

Also during my last appearance before this committee, I described a program initiated by ONR and DCAA in 1989 to help alleviate the problem of keeping up with the heavy Federal audit load. That program called the University Coordinated Audit Program, or UCAP, has proven successful at the two test universities; and so this July, ONR and DCAA are planning a second UCAP meeting here in Washington to ask 23 other universities to participate in the program.

We see this initiative as a means of maintaining the Federal audit presence at these universities while decreasing the overall audit workloads so that we can keep our university audits up to date. We believe that the system won't work without adequate audits.

Mr. Chairman, I believe there is room for improvement in every aspect of this system, from providing clear and consistent guidance, to tightening administrative procedures, from selecting and training of negotiators to ensuring adequate audit support for those negotiators. We are working all of these areas in parallel, and I believe the taxpayers have every reason to demand and to expect better performance from us in the future.

I also firmly believe that the overall situation is turning around, not in small part to all the publicity that hearings like today's and those on March 13 have given to the situation. The Navy and DCAA are developing a closer, more effective relationship. The universities are scrutinizing their own previous charges and tightening their internal oversight controls. The administration has taken the lead, as we have seen, in developing more definitive indirect cost guidelines.

I would like to conclude my remarks to you this morning with an assurance to the members of this committee that the Navy is working diligently to ensure that federally sponsored research maintains the highest standard of public accountability.

I believe the initiatives I have outlined for you today demonstrate that commitment. One thing before I relinquish the microphone, sir: with all due respect, to correct a remark that you made in your opening remarks. To your great disappointment, Mr. Newton's, and my own, we do not have a check from Stanford.

Mr. **Dingell**. You do not?

Admiral **Miller**. We do not have a check from Stanford. A check was proffered to the Government yesterday, last night, but it came with a string attached that we would not accept. The check covered some unallowable costs, but it came with an endorsement that said, acceptance of this check would mean that the Government agreed to relinquish any rights to future collecting of interest on this matter.

We refused the check. We're sending it back and we have officially notified Stanford of that. As an aside, I will tell you I immediately picked up the phone last night, and I called both the president of the university and the president of the Board of Trustees of Stanford University and expressed to them my disappointment in that approach. Thank you, Mr. Chairman. That concludes my remarks.

[The prepared statement of Rear Admiral Miller follows:]

REAR ADMIRAL WILLIAM C. MILLER
CHIEF OF NAVAL RESEARCH
TESTIMONY BEFORE
UNITED STATES HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
COMMITTEE ON ENERGY AND COMMERCE

09 May 1991

Mr. Chairman and members of the Committee, I appreciate this opportunity to testify today to update the status of overhead negotiations at Stanford University, and to tell you about some of the actions the Department has taken to improve administration of federally sponsored research at other DoD-cognizant universities.

First, I will summarize the status of the overhead rate negotiations between the government and Stanford University.

On April 9, the government notified Stanford that all Memoranda of Understanding (MOUs) existing between the university and the government, except tuition remission, were canceled effective September 1, 1990. This was done based on analysis of the best information we had available, and upon recommendations by the Defense Contract Audit Agency (DCAA), Department of Health and Human Services(DHHS), the General Accounting Office (GAO), and the Navy's own Special University Team.

The single MOU on tuition remission was retained pending Office of Management and Budget (OMB) review of government policy in this area as part of a comprehensive study of OMB Circular A-21 governing cost principles for use in federal contracts and grants to universities.

From April 9 to April 25, Stanford and the government continued to negotiate the university's FY 1991 Indirect Cost Rates, but were unable to reach an agreement. Therefore, because no additional substantive information was expected to be available in the foreseeable future, the government issued a Unilateral Rate Determination to Stanford that established for Stanford's FY 1991, a Provisional Rate of 55.5%, effective as of the beginning of their fiscal year, September 1, 1990. This rate was based on DCAA audits, supplementary information provided earlier by Stanford, and related analyses.

After audit of Stanford's final indirect cost rate proposal following the end of their fiscal year, the Office of Naval Research (ONR) and Stanford will negotiate a final rate for FY 1991, and any over or under payments during this fiscal year will be reflected in subsequent year indirect cost rate negotiations.

As I testified on March 13, 1991, to this Committee, the Office of Naval Research (ONR), acting for the Department of Defense -- and in concert with the Department of Health and Human Services and the Department of Energy -- is assigned responsibilities for overhead rate negotiations and audit resolution at certain designated universities. These functions are conducted on behalf of all Federal agencies under a "cognizant agency" concept established by the Office of Management and Budget in OMB Circular A-88.

The universities and nonprofit institutions assigned to ONR are:

Alaska, University of
Brown University
California Institute of Technology
Carnegie-Mellon University
Charles Stark Draper Laboratory, Inc., The
College of Lake County
Colorado School of Mines
Columbia University
Cornell University (Endowed Colleges)
Cornell University (Medical College)
Cornell University (Statutory Colleges)
Dayton, University of
Denver, University of
Emmanuel College
Georgia Institute of Technology
Hawaii, University of
Illinois, University of, at Chicago
Illinois, University of, Urbana-Champaign
Massachusetts Institute of Technology
McMaster University
Metalworking Technologies, Inc.
Miami Valley Research Institute
National Academy of Sciences
New Mexico Institute of Mining & Technology
New Mexico State University
Notre Dame du Lac, The University of
Pennsylvania State University
Polytechnic Institute of New York
Regis College
Rhode Island, University of
Rochester, University of
Southeastern Center for Electrical Engineering Education
Smithsonian Institution
Stanford University
Stevens Institute of Technology
Syracuse University
Toronto, University of
Virginia Institute of Marine Science
Virginia Military Institute Research Laboratories

Wentworth Institute of Technology
William and Mary, The College of
Woods Hole Oceanographic Institution
Wright State University

Management of indirect cost negotiations at these universities is assigned to two ONR regional offices, one located in Boston, Massachusetts, and the other located in Monterey, California. These field offices employ Resident Representatives to administer DoD contracts and grants, and to negotiate indirect cost rates for all government agencies at the schools under their jurisdiction. They operate from field sites, often physically located on university campuses. ONR Resident Representatives are located in Cambridge, Massachusetts; New York City; Chicago; Columbus; Washington, D.C.; Atlanta; Los Angeles; La Jolla; Stanford; Berkeley; Albuquerque; Seattle; and Austin.

Audit responsibility for all DoD-cognizant universities has been assigned to the Defense Contract Audit Agency (DCAA).

As a result of current concerns about inappropriate indirect costs having been charged to the government, the Navy has undertaken several actions intended to provide greater visibility into certain elements of university indirect costs, and to better assess the potential risk of encountering such practices at DoD-cognizant universities other than Stanford.

First, ONR and DCAA initiated a study of all Memoranda of Understanding at all universities under DoD cognizance, designed to determine if these MOUs were consistent with federal regulations, if they provided for an appropriate method of cost recovery, and if they protected the government's interests. At a minimum, this study was designed to:

- o Determine which MOUs were currently active and legally binding;
- o Obtain DCAA audits and comments on all active MOUs;
- o Negotiate revisions to each active MOU as required to resolve any issues raised by DCAA audits; and
- o Ensure that each MOU included an expiration date.

Audits have been completed by DCAA at 19 of the 20 DoD-cognizant institutions at which MOUs are employed. Audits at the 20th, California Institute of Technology, will be completed by 31 May 1991. These institutions have also been advised in writing that their currently active MOUs will either be discontinued or renegotiated by the close of the current fiscal year. I would like to add that DCAA found many of the MOUs to be reasonable and appropriate.

Second, ONR has prepared a new, comprehensive practices and procedures manual governing indirect cost negotiations, including entering into any new MOUs, with an emphasis on uniformity and consistency in the treatment of indirect costs. This new guidance has been completed and is now in distribution to all ONR University Business Affairs field representatives. Any new MOUs to be reviewed and approved under these procedures will require:

o Formal headquarters approval by the ONR University Business Affairs management of all pre- and post-negotiation clearance memoranda for indirect costs;

o Prior approval by the Office of the Assistant Secretary of the Navy (Research, Development and Acquisition) of any MOU meeting the definition of an advance cost agreement under the Federal Acquisition Regulations FAR 31.109;

o Headquarters Legal Counsel review of all business clearance memoranda and proposed MOUs prior to execution;

o Audit reports to accompany all business clearance memoranda for indirect cost rate negotiations, specifically addressing contractors' compliance with OMB Circular A-21 regarding physical inventories required to support building and equipment use or depreciation charges; and

o All interested federal agencies are to be invited to participate in the indirect cost negotiation process.

Third, in early April of this year, I sent personal letters to the presidents of all DoD-cognizant institutions asking that they review their internal controls, and ensure procedures are in place to guarantee proper cost allocations and charges to federally-sponsored research. I also enclosed with each of these letters a copy of GAO's testimony before this committee, on March 13, 1991, entitled "Indirect Costs Charged by Stanford," to guide them in looking for problem areas.

Mr. Chairman, we now see that universities are beginning to take a long, hard look at their accounting and audit procedures. They are reviewing their screening processes to ensure consistent treatment of unallowable charges and, most importantly, they are withdrawing not only the unallowable costs this new scrutiny is finding, but also other costs that may be technically allowable, but are perceived as inappropriate charges to the government in support of federal research. In November 1990, the DoD Supplement to the Federal Acquisition Regulation (DFAR) was amended to identify certain costs that were not allowable as charges to defense contracts. What many schools are doing now is using the DFAR amendment as a guide, supplemented by the

April 22, 1991 OMB draft list of unallowable costs to be incorporated in A-21, to withdraw costs that had been allowable six months ago.

For example, I understand that the Massachusetts Institute of Technology (MIT) has withdrawn costs for official functions, dinners, dinner meetings, and receptions at the president's house for the period FY 1986 through FY 1990, and other expenses that they have since deemed inappropriate.

I understand that Cornell has withdrawn all costs associated with their president's household expenses and maintenance costs, as well as meeting costs that may not have been included appropriately; and that Caltech and Columbia have also withdrawn charges.

We are now working with DCAA to establish procedures for collecting these voluntary refunds, including direct refunds for any billed costs which are found to be blatantly unallowable.

Mr. Chairman, I anticipate more charge withdrawals in the months to come as all of the nation's universities review their indirect cost records and re-evaluate their earlier interpretations of Federal guidelines.

Since I testified before this Committee last, OMB has initiated a major review of OMB Circular A-21, including tougher guidelines on both indirect cost reimbursements and internal cost allocation controls. The proposed new restrictions would prohibit universities from charging the government for reimbursement of certain costs associated with:

- Entertainment and Alcoholic Beverages
- Officers' Housing and Personal Living Expenses
- Goods or Services for Personal Use
- Memberships
- Contributions
- Advertising and Promotion
- Lobbying
- Salaries in excess of limit established by Section 213 of P.I. 101-517 for direct charges
- Travel costs exceeding standard commercial fare.
- All costs of travel by and subsistence for the institution's trustees.
- "Golden Parachute Payments"
- Defense of Fraud
- Fines and Penalties
- Commercial Insurance against Defects

I applaud this proposal, and the Navy and DoD believe it will contribute significantly to clarifying the question of indirect cost charges that may not be charged to the government.

Also during my last appearance before this Committee, I described a program initiated by ONR and DCAA in 1989 to help alleviate the problem of obtaining timely audits. That program, the University Coordinated Audit Program or UCAP, has proven so successful at MIT and Penn State that this July ONR and DCAA are planning a second UCAP meeting here in Washington to ask 23 other universities to participate in the program. We see this initiative as a means of maintaining federal audit visibility into university cost systems, while decreasing the overall audit workload so that audits can be maintained up to date.

Mr. Chairman, there is room for improvement in every aspect of the system -- from providing clear, consistent guidance, to tightening administrative procedures; from selection and training of negotiators, to ensuring adequate audit support of negotiations. We are working all of these areas in parallel, and I believe the taxpayers have every reason to demand and expect better performance from us in the future.

I also firmly believe that the overall situation is turning around. The Navy and DCAA are developing a closer, more effective, mutually supportive relationship; the universities are scrutinizing their previous charges and tightening their internal oversight controls; and the administration has taken the lead in developing more definitive indirect cost guidance.

Mr. Chairman, I complete my testimony with an assurance to you and to the members of this Committee that the Navy is working diligently to ensure that federally sponsored research maintains the highest standard of public accountability. I believe the initiatives I have outlined for you today demonstrate that commitment.

I would be pleased to answer any questions that you or other Committee members may have.

end

Mr. DINGELL. Admiral, you are free to correct the Chair any time you find him wrong. I want you to understand that. The Chair is going to recognize my good friend—I'm sorry, Mr. Newton, you had a statement. You have my apologies. I did not mean a discourtesy to you.

TESTIMONY OF FRED J. NEWTON

Mr. NEWTON. Thank you. Good afternoon, Mr. Chairman and members of the subcommittee. As you have requested, I will address the activities of the Defense Contract Audit Agency, DCAA, in auditing costs billed for Government-sponsored university research.

My comments will focus on DCAA activities since the hearing held by this subcommittee on March 13, 1991, and will particularly address the ongoing audit effort at Stanford University and the other universities we audit.

DCAA has continued to aggressively pursue resolution of the many cost allowability and allocability issues. We have found that the university promises to return money which they inappropriately billed to and received from the Government have not resulted in any refunds. The universities still hold the money. For example, Stanford University continues to hold every dollar it received from the Government for its yacht, shopping center subsidization, cocktail parties, et cetera.

Applicable regulations permit, in some circumstances, the handling of adjustments to prior year negotiated fixed rates as a carry forward to a future year's negotiation. The carry forward adjustment provisions properly apply where allowable costs incurred on research are under the amounts estimated for interim building purposes. Applying the carry forward provisions to unallowable costs can place recovery of Government payments for such costs in limbo for an extended period. It would, in effect, encourage the billing of unallowable costs as a free loan from the Government.

When the adjustments are for such unallowable costs as identified in the Stanford situation, anything less than an immediate refund is unacceptable. With this perspective in mind, I instructed the cognizant DCAA auditor, Mr. Joe Riden, to ask Stanford to issue a check. Mr. Riden was advised on April 25, 1991, by Mr. William Massey, vice president at Stanford, that a check for $924,517 would be issued within a few days for adjustments claimed on indirect costs for the period 1981 through 1988. A follow-up a week later disclosed no refund had been made.

On May 6, 1991, Mr. Massey expressed concern that issuing a check to the U.S. Treasury might not result in the proper distribution to Government agencies. On Tuesday, May 7, Stanford's counsel wrote to me advising willingness to bring the check for $924,517. I advised Admiral Miller, Chief of Office of Naval Research, of their offer, and he agreed to contact Stanford. I understand the check delivered had unacceptable conditions and was rejected by the Navy.

I would be pleased to have this refund forthcoming; however, the committee should also be aware that this amount does not include unallowable costs for 1989 and 1990.

The California Institute of Technology announced that it would withdraw about $500,000 for costs inappropriately billed to the Government. They have indicated plans to agree to an adjustment in final settlement of costs for 1987 to 1990. To the extent that the Government has previously paid for these inappropriate billings, an immediate refund payment to the Government, should be made.

The Massachusetts Institute of Technology recently announced it would repay $768,000 for charges to the Government for dinners, receptions, alcohol beverages, flowers to the president's home, et cetera. The refund has not yet been made.

While I applaud the offers to return the Government funds, particularly from those institutions who initiated their own reviews to determine the amounts, it is time to see deposits in the U.S. Treasury. Our auditors at the universities where we have cognizance are working closely with the Office of Naval Research contracting officers in attempts to get the money back.

In addition to delaying the refund, Stanford has continued delaying access to its records and its personnel. They have required every request for documents to be submitted in writing to the controller's office. Days and, in some cases, weeks go by while they screen the documents before turning them over to the auditors. The university representatives have been reluctant to have our auditors interview those personnel responsible for preparing the documentation and incurring the cost.

These conditions only stimulate adversarial relations and inefficiency. DCAA attorneys have had extensive discussions with Stanford representatives in recent weeks. One result has been the issuance by Stanford on May 6, 1991, a letter to DCAA identifying new procedures for obtaining access to documents and personnel. The procedures sound like a significant improvement. The proof will be in the implementation.

In prior testimony to your subcommittee, I reported on significant problems with unsupported cost allocation methods at Stanford. The conditions described include a continuation in current billing rates proposed by Stanford of highly inappropriate costs and inequitable cost allocations.

These problems have been relieved by strong action by the Office of Naval Research. On April 25, 1991, they cancelled for the current fiscal year virtually all of the Memoranda of Understandings and established a current year billing rate of 55.5 percent. This reduction of Stanford's proposed 74 percent rate equals about $20 million.

Conditions at the Massachusetts Institute of Technology, commonly referred to as MIT, were previously reported as being much better than at Stanford. With regard to managerial cooperation, that remains the case. However, there are problems. One is the need to resolve questions regarding the allocation of library costs. These costs have been allocated over the 5-year period 1986 through 1990 on the basis of a fixed 49 percent rate authorized by a Memorandum of Understanding executed in August, 1985. A copy of the memorandum is submitted as an appendix to my statement.

The allocation rate computation on the second page of the memorandum excludes undergraduate students from the allocation. Some estimates of the impact of this exclusion indicate an adverse impact to the Government of about $1 million per year. The cause of this condition appears to be the result of some confusion on the part of everyone involved, including the DCAA auditors, at the time the memorandum was developed.

If the allocation had been the subject of periodic cost analysis by the university as the application regulations proscribe, the perpetuation of the questionable allocation exclusion would likely have been avoided. Most certainly, more current data should have been used for this significant cost allocation. Our auditors are working with the Office of Naval Research to resolve this issue. We are continuing our audit of other MIT costs.

We're also in the midst of audits at all of the 40 universities where we have audit cognizance. The results are not yet available, but preliminary assessments indicate there are some cost allocability and allowability problems.

Examples are: No. 1: Transaction tests at Carnegie Mellon University disclose unallowable direct and indirect costs which have been included in the Government billings. The auditors sought to expand their sample, but university representatives cited difficulty in running a data retrieval program. Subsequently, they asked the DCAA auditors to stop their audit until an internal review might be performed.

No. 2: The University of Hawaii is using an unsupported alternative allocation procedure for library cost. The cognizant DCAA auditor advises that the Government is being billed excess costs estimated at $500,000 annually.

Generally, the auditors indicate that there is considerable concern being expressed by university managers, and effort is being taken to screen out the type of costs which might be embarrassing if disclosed.

Regarding responsibility for university cost problems, I will emphasize that while effective Government oversight is needed, it is fully and completely the responsibility of the universities to live up to the terms of their contracts and grants. It is up to the university management, not the Government employee, to set a clear tone from the top that responsible and ethical conduct will prevail in all matters affecting the use of public funds.

The Department of Defense has for several years been encouraging increased contractor self-governance. It is a program prescribing voluntary procedures for improving systems of internal control. While contractors were generally slow to make commitments to participate, significant progress has been made in the past year. We have been seeing positive action at some of the universities, apparently motivated by increased Government attention, including the investigation by your subcommittee.

In any event, more action is needed by university executives. Firm procedures need to be established, including increased budgetary controls and internal testing, to assure compliance with applicable regulations. By managing the cost better, I believe they can avoid the continuation of intense public scrutiny and distrust, and get on with the business of performing the research our country needs.

Both the university managers implementing contractual requirements and the Government auditors benefit from having applicable regulations which are easily understood and consistent. There are presently some significant differences between the cost regulations applicable to defense contracts and those applicable to defense grants and non-defense contracts and grants. The Office of Management and Budget has proposed major changes to the university cost regulations which appear to be for the purpose of eliminating inconsistencies. I view this as a positive step.

There has been some discussion about solving the university indirect cost problems through the use of caps, which may be described as ceilings on the indirect rates or amounts which may be charged to Government contracts or grants.

While I applaud any action toward resolving the problems, reliance upon caps for cost control is not a panacea, and can present its own unique problems. Too often, caps have the same effect as squeezing on a long balloon. The accountants may exercise liberal interpretations of cost-accounting criteria to just move the costs around.

For example, there have been, for some time, caps used to control independent research and development charged to defense contracts. Auditors will tell you that it is rare when a contractor spends less than the cap, and it is usual to find differing interpretations on what should be classified as independent research and development costs. The contractor interpretations favor avoiding the caps, so that greater cost reimbursement may be obtained.

If caps are used, and I am not opposed to them, it is imperative that provisions be made for consistent accounting practices, and as precise a definition of the cost subject to each cap as possible.

If the current policy of reimbursing universities for the actual costs incurred in performing Government research is continued, accounting criteria for fairly measuring those costs, accompanied by guidelines on reasonableness, and specific allowability provisions should be sufficient. Since there may be some who would attempt to misuse the accounting criteria, the management of public funding provided for research should be a factor in deciding whether to award future contracts or grants.

Mr. Chairman and members of the subcommittee, this concludes my statement. I will be pleased to answer any questions.

Mr. Dingell. Mr. Newton, your testimony has been very helpful.

The Chair has got a very difficult problem on its hands. There is a vote on the House floor, which is going to require that I leave. I am going to request that, or rather, I am going to recess the subcommittee for 15 minutes. It is possible that if Dr. Rowland comes back earlier, that he will start it up a little before that time, so that we can get this business done.

The Chair apologizes to all for this inconvenience, and we will recess for approximately 15 minutes. If Mr. Rowland comes back earlier, he will start it up earlier, while the Chair is getting back.

The subcommittee stands in recess for that period.

[Brief recess.]

Mr. Dingell. The subcommittee will come to order.

Gentlemen, the Chair apologizes to you for the fact that I was called away for a vote. We will proceed now with questions; and I want to thank both you, Admiral Miller, and you, Mr. Newton, for your very fine statements and for the good work that you have been doing on the matter before us.

Mr. Newton, in your testimony today, you described the situation at Carnegie-Mellon University, where your auditors were identifying both unallowable direct and indirect costs being billed to the Government.

Would you please, as a kindness to the committee, elaborate on what kind of improper charges your auditors found at Carnegie-Mellon, both with regard to direct and with regard to indirect costs, if you please?

Mr. NEWTON. I have with me a couple of examples of indirect charges. I do not have an example with me of the direct charging incidents.

In the indirect pool, in our audit for fiscal year 1988 at Carnegie-Mellon, our auditors observed $160,000 of commencement costs which were allocated to the Government. Commencement costs are expressly unallowable under the provisions of A-21.

We also observed an incident where Carnegie-Mellon University had a group at the Seven Springs Ski Resort, and chose to include that in the allocation of their fiscal year 1986 overhead to the Government. The amount that they included had $4,000 for lodging and another $3,000 for meals and liquor charges.

Mr. DINGELL. Any ski-lift charges?

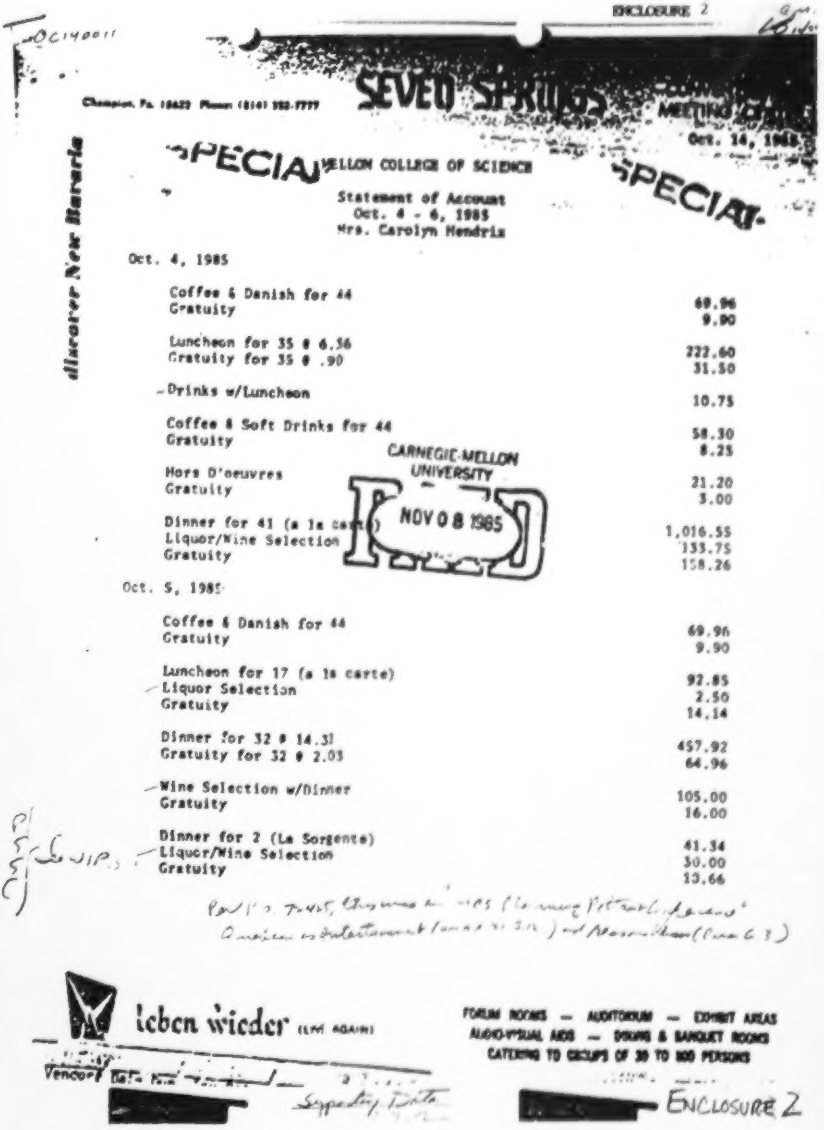
Mr. NEWTON. No, sir, I do not see the ski-lift charges included on the invoice.

Mr. DINGELL. Could you give us copies, please, of the invoice?

Mr. NEWTON. Yes, sir.

Mr. DINGELL. Without objection, that will be inserted in the record.

[The information follows:]



ENCLOSURE 2

OC140011

Champion, Pa. 15622 Phone: (814) 352-7777

SEVEN SPRINGS MEETING

Oct. 14, 1985

SPECIAL MELLON COLLEGE OF SCIENCE SPECIAL

Statement of Account
Oct. 4 - 6, 1985
Mrs. Carolyn Hendrix

Discover New Bavaria

Oct. 4, 1985	
Coffee & Danish for 44	69.96
Gratuity	9.90
Luncheon for 35 @ 6.36	222.60
Gratuity for 35 @ .90	31.50
Drinks w/Luncheon	10.75
Coffee & Soft Drinks for 44	58.30
Gratuity	8.25
Hors D'oeuvres	21.20
Gratuity	3.00
Dinner for 41 (a la carte)	1,016.55
Liquor/Wine Selection	133.75
Gratuity	158.26
Oct. 5, 1985	
Coffee & Danish for 44	69.96
Gratuity	9.90
Luncheon for 17 (a la carte)	92.85
Liquor Selection	2.50
Gratuity	14.14
Dinner for 32 @ 14.31	457.92
Gratuity for 32 @ 2.03	64.96
Wine Selection w/Dinner	105.00
Gratuity	16.00
Dinner for 2 (La Sorgente)	41.34
Liquor/Wine Selection	30.00
Gratuity	10.66

CARNEGIE-MELLON UNIVERSITY
NOV 08 1985

VIPs

[illegible]

leben wieder (LIVE AGAIN)

FORUM ROOMS — AUDITORIUM — EXHIBIT AREAS
AUDIO-VISUAL AIDS — DINING & BANQUET ROOMS
CATERING TO GROUPS OF 30 TO 300 PERSONS

Vendor Data [illegible]

[redacted]

Supporting Data

[redacted]

ENCLOSURE 2

[illegible]

SEVEN SPRINGS CONVENTION & MEETING CENTER

Discover New Horizons

Oct. 6, 1985

Coffee Break for 44	46.64
Gratuity	6.60
Miscellaneous Charges	
Coffee Shop	3.88
Room Service-Hospitality Receptions	141.40
Individual Lounge Charges	77.50
Long Distance Phone Calls	35.90
Subtotal	$2,923.17
Individual Lodging Statements	4,008.00
Total Balance Due	$6,931.17

If you have any questions concerning this statement, Mrs. Hendrix, please contact me personally.

Thank you,

Diana M. Snyder

Diana M. Snyder
Billing Manager

leben wieder (LIVE AGAIN)

FORUM ROOMS — AUDITORIUM — EXHIBIT AREAS
AUDIO-VISUAL [illegible] DINING & BANQUET ROOMS
[illegible] OF 30 ... 600 PERSONS

R14

Mr. **Dingell**. Now, you go on to state that, when your auditors attempted to expand their sample, Carnegie-Mellon tried to prevent this by citing difficulty in running the data retrieval system in its accounting system; is that correct?

Mr. **Newton**. Yes, sir.

Mr. **Dingell**. What were the difficulties?

Mr. **Newton**. I do not know what their problem was. I am somewhat familiar with the program, because the program that is included in their system is a software package called Datatrak, which was developed by DCAA. We do not normally encounter problems with running it once it has been installed. It is a sampling process, assuring that you are able to extract appropriate random samples from various universes.

The auditors did continue, and are in fact continuing their audit effort, notwithstanding the difficulties espoused by the university. It just makes the timing of the effort more protracted.

Mr. **Dingell**. Then you are telling me that Carnegie-Mellon has yet to present the sample being expanded; is that correct?

Mr. **Newton**. Yes, sir.

Mr. **Dingell**. OK. Now, do you believe that these problems were in fact legitimate? In other words, did Carnegie-Mellon have a data retrieval system problem, or were they trying to slow the audit?

Mr. **Newton**. I am suspect of the conditions, but I do not know what their intentions were.

Mr. **Dingell**. Now, then you said that they subsequently had asked DCAA to stop their audit and let Carnegie-Mellon conduct an internal review. Is that correct?

Mr. **Newton**. Yes.

Mr. **Dingell**. That is rather unusual, is it not?

Mr. **Newton**. Not these days at universities, sir. the universities seems to be very much interested, in general, in performing their internal reviews. When we seem to come in and find something which might be embarrassing, they prefer to find it themselves.

Mr. **Dingell**. Now, has DCAA stopped its audit, or will you continue to pursue the matter while Carnegie-Mellon does its own internal review?

Mr. **Newton**. We will continue our review. We are in fact continuing our review. It is more difficult to do so without having the automated sampling process working for us.

Mr. **Dingell**. Does the Navy have contractual rights to have the assistance of the university in conduct of the audit, including use of automated systems?

Mr. **Newton**. I do not believe that we have a specific contractual provision of that nature. It generally works out to the advantage of a contractor who you are auditing as well as to the auditor, for the use of these systems. It is more efficient for everyone.

Mr. **Dingell**. Now, turning to MIT, my understanding is you and MIT have collectively identified in excess of three quarters of a million dollars in inappropriate charges to the Federal Government. Is that correct?

Mr. **Newton**. Yes, sir, that is my understanding.

Mr. **Dingell**. Has MIT taken upon themselves to voluntarily scrub their own accounts?

Mr. **Newton**. Yes, they have. They have been very active in attempting to perform reviews themselves. The attitude seems to be one of cooperation, at MIT.

Mr. **Dingell**. I was about to lead to that question.

What number, or percentage, of their accounts have they scrubbed?

Mr. **Newton**. I do not know the number that they have scrubbed.

Mr. **Dingell**. What has your staff done to validate MIT's scrub and to ensure that it is thorough and complete?

Mr. **Newton**. We are examining the tests that they have performed, examining the workpapers, and we will be trying to assure ourselves that the sampling procedures have been adequate. We are going to assure ourselves that all of the vouchers in a particular account that might be deemed sensitive, such as one on the president's personal expenditures. We would be examining that to assure that the tests they have performed are sufficient and reliable.

Mr. **Dingell**. Admiral Miller?

Admiral **Miller**. Yes, sir. I would just like to add that MIT is one of the test schools in which we have tried out the University Coordinated Audit Program. One of the benefits of going into that program is that the DCAA has access to the working papers of their internal audits, they cannot hold them back as proprietary. So we not only have their audit report, but the auditors can go in and actually look at their work papers. We can get some degree of confidence on whether we need to go in and re-audit it ourselves, or whether we can accept their results. That is a big advantage.

Mr. **Dingell**. Now, can you describe MIT's scrub as being adequate or inadequate, based on any particular review that you have performed; or is that answer yet before you?

Mr. **Newton**. That answer is yet before us, sir. We are ongoing with our review.

Mr. **Dingell**. Now, I gather that the presence of your audit staff in the case of MIT, as in the case of all others, has, by its increased presence, stimulated considerable cooperation and additional effort on the part of the universities in connection with these sundry audits; is that correct?

Mr. **Newton**. Yes, sir.

Mr. **Dingell**. Now, gentlemen, in addition, there is a concern about a Memorandum of Understanding entered into between the Government and MIT concerning allocation of library costs.

Would you please explain to us what the current situation is regarding that Memorandum of Understanding?

Admiral **Miller**. Yes, sir. That Memorandum of Understanding has expired. Had it been still in effect in 1991, we would have cancelled it.

It is an example of why we went back and told all of our DOD-cognizant universities that, effective the end of this year, we were not going to have any MOU's unless they have been renegotiated under these new, more rigorous procedures.

In looking at that MOU and how it was arrived at, we can see that there are deficiencies in the way the MOU was put together. I can tell you that had it come forward for approval and legal review at headquarters, as we are demanding now, it would have had to go all the way up to the Navy Acquisition Executive to get approved.

It would have never survived that process, or it would have been improved along the way. That is the current status of that MOU.

Mr. DINGELL. What about the status of these and other MOU's? Are they subject to being cancelled by the Navy and, if so, as of what time, and can they be cancelled retroactively to the beginning of the year in which the payments are made?

Admiral MILLER. We are cancelling, or formally renewing under the new procedures, every MOU at every DOD school this year. If we take no action, it is cancelled as of the end of the year. If the school believes or the Government believes there is value in having an MOU, it has to be renegotiated this year and re-validated.

For example, in the case of MIT's library costs, they have already initiated a new library study to serve as a basis for future allocations of libraries, that we will consider after we see what they provide us. As of right now, there is no MOU on libraries at MIT.

With respect to retrospective cancellation, I am afraid that we will probably be chasing that one for some time from a legal standpoint when the Government can or, as the universities would claim, cannot cancel MOU's that covered costs in completed years, is still not clear.

Mr. DINGELL. Not costs of current years.

Admiral MILLER. Not current years.

We are addressing that through our legal staff and developing the Government's position so we are on sound legal grounds to address it.

Mr. DINGELL. Now, I gather that the Government, under the particular MOU that we are referring to, was picking up about 49 percent of all library charges. I gather that the methodology and the calculation was flawed in that they left out undergraduate students in the population study, for example.

I gather that, on the basis of DCAA audits, that we should be paying somewhere around 34 percent, not 49 percent. Can you tell me what the savings of that would be?

Admiral MILLER. I have not calculated those savings. We had to pull the string on that particular case, because the MOU was not clear nor was the documentation.

So, in going back and researching the history of this, we find that, back in 1985, the university actually did a library study that would have supported a rate in the high 50's.

DCAA audited that, had significant problems with the way that study was conducted. One problem was the allocation of time for the research assistants. The library study said a research assistant ought to have 100 percent of his time and, therefore, 100 percent of his relative cost allocated to research, as opposed to education, and the Government objected to that.

In subsequent negotiations, the library study itself included undergraduates, but in the negotiations the library study was put aside and not accepted by the Government. What the negotiator did at that time was to negotiate a position between the Government auditors' position and MIT's library study position, which was 49.5 percent.

The documentation of that decision is, in fact, the library MOU that existed up until last year. That documentation, as we all see by looking at it, does not tell that story at all. That is why I said that it would never have survived the logic test in the current procedures.

Mr. Dingell. Your recommendation with regard to an equitable library allocation today would be what?

Admiral Miller. I do not have personal knowledge enough to give you an answer. I would have to go on the allocation that has been negotiated for this year, which is, 49 percent. That was based on the past history over the late 1980's, which had been actually audited by DCAA.

Mr. Dingell. Mr. Newton, would you have a comment as to recommendations you would make with regard to that?

Mr. Newton. We have not seen anything which would indicate that an allocation method other than that as prescribed in OMB Circular A-21 should be used. That Circular prescribes the allocation on the basis of user groups, which would include the undergraduates.

Mr. Dingell. Could you give us a percentage?

Mr. Newton. I do not have an exact percentage available. It is a significant amount less.

Mr. Dingell. Well, if you would want to submit a figure for that for the record, gentlemen, it would be appropriate.

Mr. Newton. Yes.

[The information follows:]

DCAA's calculation of the library allocation rate using the default method prescribed in OMB Circular A-21 results in a rate of 21 percent.

Mr. Dingell. Now, Mr. Newton, we have here a situation where we find that there are flawed MOU's at Stanford which work against the Government's interest. I detect we now have found that there is a strong probability that there are flawed MOU's in operation at MIT. Is that correct?

Mr. Newton. Yes.

Mr. Dingell. Is there any reason, gentlemen, to assume that there is not peril with regard to MOU's which are outstanding against—or rather, with regard to these kinds of expenditures with other colleges and universities?

Mr. Newton. I believe that any alternative allocation which is subject of a Memorandum of Understanding should be held accountable under the criteria that is laid out in Circular A-21. That criteria has some very precise supporting documentation requirements, including updating of that supporting documentation at least every 2 years. If that is not done, then whatever other alternative allocation procedure that is there should be put aside.

Admiral Miller. I would agree with Mr. Newton on that, but add, that the MOU's that affect the indirect cost collection rate are advance agreements in the context of the Federal Acquisition Regulations. In fact, contracting officers are encouraged by the FAR, the Federal Acquisition Regulations, to enter into advance agreements in cases where the allocability or allowability of a specific cost may come into doubt year after year. That is why, in the future, we are bringing these agreements all the way up to our

Navy Acquisition Executive, at the Assistant Secretary of the Navy level, before we enter into such advance agreements.

We have demonstrated that if you do not have adequate review and oversight of the process, it can result in agreements that are not in the Government's interest, and that is why we have changed our procedures.

Mr. DINGELL. Now, gentlemen, I guess this is particularly to Mr. Newton, but let us look at Lincoln Laboratory. This is a quarter-of-a-billion-dollar operation. It is 10 to 12 miles from the main campus at MIT. It is, in effect, a single research contract with the Department of Defense.

Now, it is my understanding that the Lincoln Laboratory picks up something like $25 million in indirect costs from the main MIT campus. Is that correct?

Mr. NEWTON. Yes,,that is correct.

Mr. DINGELL. Now, I am curious. What is DCAA doing to audit or review this MIT allocation to the Lincoln Laboratory?

Mr. NEWTON. We are examining the possibility of being able to make recommendations for a lower allocation of the overhead costs. We are examining it in light of some provisions that are available in cost accounting standards.

There are provisions which give guidance for dealing with a single contract or single final cost objective in the allocation of general administrative expenses. We are using the cost-accounting standards criteria to try to develop what we might be able to recommend to the contracting officer. I hope that that audit will be concluded soon with a recommendation.

Mr. DINGELL. Let us take a look at this.

Lincoln Lab is a single contractor to the Federal Government. Right?

Mr. NEWTON. Yes.

Mr. DINGELL. That is the only function that they carry out. So, would I be unfair in assuming that Lincoln Lab was getting both its basic research contract money plus an overhead which was being allocated to the cost of the university? Would I be unfair in coming to that assumption?

Mr. NEWTON. They would have the overhead that should be the amount which is allocable to the Lincoln Lab from the university. That allocation should be complying with those provisions requiring a beneficial causal relationship for measuring the amount which would go to it.

Mr. DINGELL. OK. So, Lincoln Lab, then, is getting—is financed from, essentially, a contract with two parts. The first is the direct money that they get to carry out the work. Is that right? The second is the part that goes to the payment of overhead costs that are attributed to its share of the university's total overhead costs. Is that a fair statement?

Mr. NEWTON. I believe it is all part of the same contract.

Mr. DINGELL. It is all part of the same contract, but it is one contract in two parts.

Mr. NEWTON. You might categorize—there are two elements of cost that are being charged to that contract, direct and indirect.

Mr. **Dingell.** So, Lincoln—I think we have established that there is a high probability that Lincoln is already getting its own overhead costs allocable to its part of the operation.

How, then, would a contract that is done on the main campus of MIT have any overhead component that would be related to the existence or non-existence of Lincoln Laboratories?

Mr. **Newton.** The Lincoln Lab would be incurring many expenses which might otherwise be treated as an indirect expense if it were an integral part of the university.

Mr. **Dingell.** It is 10 to 12 miles away.

Mr. **Newton.** Well, whether it is or not, if it is using the services—for example, if they had a computer center, they had other types of administrative activities there, the accounting for it could be properly done where there would be an allocation, but I would expect—and to this point, I have to speculate about what is available to them at the laboratory itself.

I would expect that there are functions being performed at the lab which would normally be treated as indirect but, in the case of this lab, since it is one contract, that it would be charged as a direct charge to that single contract.

It would not be part of the indirect expenses. The only portion of the charges which would be properly indirect would be those expenses from the university itself which have a beneficial or causal relationship to the operation of Lincoln Lab.

Mr. **Dingell.** All right. Now, I think we are coming to an understanding, and essentially, you and are coming, I think, the agreement that, since Lincoln Lab is probably compensated for all overhead costs associated with it or since the university is compensated for all overhead costs associated with the presence of Lincoln Lab, that to assess any further overhead charges against other Government contracts because of the presence of Lincoln Lab would be incorrect and, essentially, constitute double billing. Is that a fair appreciation of what we are agreeing on?

Mr. **Newton.** There could be circumstances.

Mr. **Dingell.** Now, have we looked at that yet?

Mr. **Newton.** We are looking at it.

Mr. **Dingell.** I see. Admiral, I apologize.

Admiral **Miller.** Yes, sir. There are other examples besides Lincoln Laboratory, where university-run facilities that belong to the Government have a separate overhead rate. In fact, they do not get to charge their customers the same rate as on-campus research.

For example, at Stanford, the Stanford Linear Accelerator has its own rate that is pegged to its cost as opposed to being able to charge its customers the rate for on-campus research. Because they are remote, like Lincoln Laboratory and——

Mr. **Dingell.** They are separately compensated.

Admiral **Miller.** They are separately compensated, so they have their own overhead rate.

Mr. **Dingell.** So, if Lincoln Labs or this accelerator that they are referring to, or Livermore were to charge—were to find that overhead was to be charged against them, because that overhead is already separately compensated, you would essentially have double-billing of the Government; is that right?

Mr. **Newton**. Well, it depends on how they are segregating the costs, as to whether there would be double-billing. If the only allocable overhead, or the only overhead that is allocated to the laboratory is that which has a beneficial or causal or relationship, I would not see a double billing occur.

Mr. **Dingell**. We do not know that though until it is looked at, do we?

Mr. **Newton**. That is correct, sir.

Mr. **Dingell**. I would infer, from our comments here that that is something that should be looked at?

Mr. **Newton**. Absolutely.

Mr. **Dingell**. That is good. I am sure you are.

Mr. Newton, has the Government gotten back any of the money from over-charges from MIT?

Mr. **Newton**. No, sir.

Mr. **Dingell**. No. Now, I guess the summary would be that the situation at MIT is similar to Stanford, in that we have hundreds of thousands, potentially millions of dollars in inappropriate charges that are then being billed to the Government. In addition, I detect that you have told us that there are MOU's that are operating that are not properly supported, and some overall allocation concerns. Is that a fair statement, Mr. Newton, and Admiral?

Mr. **Newton**. We have overall concerns that are similar. I would like, if I might, to address the point of getting the money back. At MIT, they are holding out that they are giving it back to the Government. The way that they are approaching this is like many of the other universities. They are saying they are going to do it through the carry forward provisions. The carry forward provisions, I believe, are being grossly misinterpreted by anyone who views that provision as being available for dealing with unallowable costs.

Now, we have, as the Admiral has indicated, we have lawyers looking at it for interpretations, looking at the circular. I am not a lawyer, but I can read. I look at the A-21 provisions, and I find that, under the Provision C.1., which describes composition of total cost, it says: "The cost of a sponsored agreement is comprised of the allowable direct costs incident to its performance, plus the allocable portion of the allowable indirect costs of the institution, less applicable credits," as described later in the circular. The emphasis on describing what cost are is clearly "allowable".

Mr. **Dingell**. It still does not allow double-payment though?

Mr. **Newton**. Pardon me?

Mr. **Dingell**. It still does not allow double collection?

Mr. **Newton**. That is correct. It does not. It also does not allow, in my view, the consideration of unallowable cost in the provision for carry forward provisions. Under the circular provision J.5., it says: "When a fixed rate is negotiated in advance for a fiscal year—or other time period—the over or under-recovery for that year may be included as an adjustment to the indirect cost for the next rate negotiation."

It does not mention unallowable cost. It does not give anything which, to me, in reading this document, would suggest that there is an intended variance from the prior section, which describes what kind of costs we are dealing with. So, for MIT or any other university to say we have identified these 700 some-odd thousand dollars of unallowable costs, and we are going to give them back to the Government through the carry forward provisions, it is like smoke and mirrors, it does not work, we will never get it.

Mr. DINGELL. You are saying it should be collected in cash money, not deferred to the following year and not allowed to vanish somewhere in the process?

Mr. NEWTON. Yes, sir. I think anything other than an immediate refund payment to the Government is unacceptable.

Mr. DINGELL. I agree with you fully.

Mr. Newton, let us turn now to the MOU with MIT concerning the Library Study. Who is the fellow who negotiated that with the Government, or with MIT? A fellow by the name of Forrester, wasn't it?

Admiral MILLER. Yes, sir, that is correct, Mr. Forrester.

Mr. DINGELL. Forrester, I guess. What is he doing now?

Admiral MILLER. He is now working for MIT.

Mr. DINGELL. Working for MIT. So, shortly after he negotiated the MOU he went to work for MIT?

Admiral MILLER. No, sir. Not shortly thereafter. In 1985, Mr. Forrester's duties were changed. Prior to 1985 he had been the ONR on-campus representative at MIT. In 1985, he became the ONR representative at Harvard University.

His duties at Harvard extended for some 2½ years and then in the middle of 1988, Mr. Forrester decided to retire. Before he did, he very correctly got a legal opinion from the ethics official, under the provisions of law and regulation within the Department, with respect to whether he could accept employment at MIT or at Harvard. He was specifically considering a job that he understood to be open at MIT.

He was advised that because he had not had a substantive connection with MIT, in a business sense, for over 2 years, that he could take a job a MIT, but he could not take a job at Harvard.

It is my understanding that, in addition, he is not engaged in any sort of job today where he is representing MIT to the Government. In fact, it is my understanding that he is working in their purchasing shop and enforcing Government regulations on MIT subcontractors.

Mr. DINGELL. Say that again. He is now in enforcing Government regulations?

Admiral MILLER. He is ensuring that subcontracts MIT let for Government contracts have the provisions in them that are required. He is using the expertise he got in the Federal Government to help MIT ensure that their subcontractors are complying. Now, that is what I hear from my staff, and that is the extent of my knowledge on that.

Mr. DINGELL. Now, Mr. Newton, in your testimony, you pointed out the University of Hawaii. Your testimony states that the DCAA auditor at Hawaii says that the Government is being billed in excess cost estimated at some $500,000 annually. Can you give us an idea of some of the types and kinds and areas of charges that make up this $500,000 annually overbilled to the Federal Government?

Mr. **Newton**. It is my understanding, sir, that we are dealing with the allocation procedure for the library cost. There is a Memorandum of Understanding or has been one at that university, which permitted an alternative allocation procedure. There is not one strictly based on the user applications, as prescribed in circular A-21. It is that difference—that inequity, that the auditor perceives to exist, as a result of this alternative allocation, which is resulting in that excessive billing to the Government.

Mr. **Dingell**. How long had this been going on?

Mr. **Newton**. I do not know when it started. It has been going on multiple years.

Mr. **Dingell**. Had this been identified at any time prior to the arrival of the—rather of the fact that Stanford and its behavior came to the attention of DCAA and the Congress and the committee?

Mr. **Newton**. I believe that there have been audit exceptions asserted previously, but I am not certain on that point.

Mr. **Dingell**. You say audit exceptions?

Mr. **Newton**. Audit exceptions. Yes, sir. I believe that the auditor had reported problems with this allocation previously; but I do not have——

Mr. **Dingell**. What were those exceptions reported by the auditor? When did they occur? What was done about them?

Mr. **Newton**. I will have to provide that to you for the record.

Mr. **Dingell**. Would you please?

[The information follows:]

Exception: Allocation of Library Expenses for Fiscal Year 1989.—The university uses an alternative allocation method as described in a Memorandum of Understanding dated 1 July 1988. The alternative method is not supported by the required cost analysis study. The auditor recommended an allocation in accordance with the OMB Circular A-21 default method. The impact on government contracts is about $580,000 in 1989.

Date Reported: 11 February 1991.

Status: Awaiting resolution.

Note: There are a number of other exceptions that have been previously reported by the auditor. Upon completion of the audits of fiscal years 1990 and 1991, similar exceptions will be reported.

Mr. **Dingell**. Now, in March, you testified that Cal Tech had removed approximately $500,000 from their claim cost between 1986 and 1990. Could you give some examples of what was included in those costs?

Mr. **Newton**. One of the costs was the cost of a retreat at Lake Tahoe. There were other types of costs that we had cited that are included in there—entertainment or personal expenses of that nature. Again, we have a university that is indicating that they, in effect, are giving it back to the Government, by use of the carry forward provisions, as opposed to giving the Government a refund check.

Mr. **Dingell**. I detect that you are telling me that the carry forward provisions, with regard to Cal Tech will work about as well as they would with regard to MIT; is that correct?

Mr. **Newton**. That is correct.

Mr. **Dingell**. Again, you do not counsel that those should be utilized for that purpose?

Mr. NEWTON. I absolutely believe that unallowable costs should not be a part of the carry forward provisions.

Mr. DINGELL. Now, did Cal Tech withdraw the charges on their own volition, or were they identified by your staff as possible areas of vulnerability to the school?

Mr. NEWTON. They were identified by the university.

Mr. DINGELL. Beg pardon?

Mr. NEWTON. They were identified by the university.

Mr. DINGELL. By the university.

Mr. NEWTON. It's my understanding in voluntary action.

Admiral MILLER. I might also add that in some cases they withdrew the entire cost pool, not just where they found that the cost pool contained questionable charges to the Government, but also where they recognized it as flawed.

Mr. DINGELL. OK, now after the school removed these charges, did your staff request to see the transactional detail on the items or to look at other years?

Mr. NEWTON. I presume they would have. That's a routine procedure.

Mr. DINGELL. Was that what triggered the withdrawal of the entire pool, Admiral?

Admiral MILLER. No. The withdrawal of the entire pool was a Cal Tech initiative. That's the way they announced it to us.

Mr. DINGELL. Now these costs and these claims were certified, were they not?

Admiral MILLER. They would have had to be certified since that law came into provision. Yes, sir.

Mr. DINGELL. Now does your Agency have an interest in reviewing these transactions in view of the fact that the costs were certified and that there is still a potential for false or fraudulent claims?

Admiral MILLER. I believe we should look at that if we have not already. It is important that we use that as a basis for evaluation not only of that pool but of the university's internal controls. If it demonstrates that they do not have adequate internal controls, it would cause us to have doubts about other cost pools.

Mr. DINGELL. So I gather then you intend to pursue these other matters?

Admiral MILLER. Yes, sir. That's correct.

Mr. DINGELL. Now gentlemen, the committee understands that the audit is still continuing on fiscal years 1986, 1987 and 1988. Can you tell us what other findings or questions have been raised about Cal Tech's indirect costs?

Mr. NEWTON. I don't have the details of the findings at this point. Those audits are in process and we would be happy to provide copies of the audit reports to you when they are completed.

Mr. DINGELL. Would you do that for us, please?

Mr. NEWTON. Yes, sir.

Mr. DINGELL. Now gentlemen, we understand that the audit staff or rather your audit staff is also reviewing internal controls and other aspects of Cal Tech's operations. Can you tell us what are these areas and what are your preliminary conclusions on these matters?

Mr. **Newton**. One of the areas of concern that we have is internal controls. There, as well as at most of the other universities, is the absence of a routine ongoing process for identifying and screening out unallowable costs.

We are looking at that. We are also looking at the internal review procedures there as well as at other universities and generally speaking I can say that we have not been finding the internal review procedures to be as forthcoming as they should be, as effective as they should be.

They do exist but we have been trying to work with the university managers to achieve a realization that more effective internal reviews are needed and generally we have been receiving cooperative comments that they might do so.

Admiral **Miller**. I believe that is a significant fact, Mr. Chairman, if I might intercede here.

Mr. **Dingell**. Sure.

Admiral **Miller**. I believe that the majority of the universities with which we deal recognize that there is a new environment out there, that the rules of the game have changed and that what had been acceptable in the past is not necessarily acceptable in the future.

I believe that not only must we look to the universities to have that recognition, but hopefully in our Government's consideration of the rules themselves. We need to improve A-21, to reduce the ambiguity and simplify the rules so that auditors and internal control people on either side will not have these arguments in the future.

Mr. **Dingell**. Now gentlemen, you have mentioned other cost allocability and allowability problems besides MIT, Carnegie-Mellon, Hawaii, Stanford and Cal Tech. Have DCAA audits at other universities also identified problems?

Mr. **Newton**. Yes, we have.

Mr. **Dingell**. Could you name the other schools and what you have in the way of fairly concrete findings?

Mr. **Newton**. We have conditions, as I have already mentioned when we were talking of internal controls; difficulty in finding adequate screening processes in general, but because of the fact that the audits are ongoing now, and I am not aware of the status of exit conferences which would be a normal matter of conduct with the conclusion of any given audit, I would prefer if I may to wait and provide that information for the record.

Mr. **Dingell**. That would be appropriate. Without objection, so ordered.

[The information follows:]

Names of other schools where DCAA has fairly concrete findings (as of 22 May 1991): (1) University of Dayton (unallowable personal expenses of the university president); and (2) Pennsylvania State University (unallowable advertising costs).

Audits are ongoing for all open years at universities under DOD cognizance.

Mr. **Dingell**. Now Mr. Newton, we have kind of come to the conclusion on the basis of your testimony and Admiral Miller's testimony and also on the basis of the testimony of Mr. Kusserow and the General Accounting Office that we have some systematic and systemic problems which are existent across the country.

Do you agree with that statement?

Mr. **Newton**. Yes.

Mr. **Dingell**. What would be a good solution to these problems?

Mr. **Newton**. As far as the accounting areas I think that the step that is underway with the OMB efforts to try to better define and provide better guidelines for identifying unallowable costs, that that is something that is sorely needed.

We need to have the regulations be consistent between those which are for defense contracts and those which are for the nondefense grants and contracts. We presently don't have that condition and it is a confusing situation for everyone involved, both in the university management and ourselves. I hope that this effort will improve that.

There are explorations I know and deliberations going on on the possibility of putting caps in on various elements. I have great reservations about whether that is going to be a successful venture in correcting any of the problems that we have. I am really quite concerned that more problems might emanate from that. There might be more temptation in fact for fraudulent conduct insofar as if there is a manager who is concerned about having achieved the ceiling in their level of expenses, there may be temptation to start charging those costs to something else intentionally, which would be fraudulent conduct.

I think what we need is a greater effort on the part of the university management to set a clear tone from the top to all of their employees that there will be ethical conduct and integrity in the application of the existing accounting rules and regulations.

Mr. **Dingell**. Now you heard Mr. Kusserow's comments this morning.

I believe he did not refer to this in great detail in his delivered statement, but in his prepared statement, of which he delivered a summary, he said this about OMB guidance A-21. He said:

> In our opinion the current version of OMB guidance A-21 does not provide incentives to schools to minimize or contain costs allocated to Federal research projects. Basically A-21 permits universities to charge expenses to Federal research when these expenses are allowable, allocable and reasonable. Costs are considered reasonable if the nature of the goods or services acquired or applied and the amount involved therefore reflect the actions that a prudent person would have taken under the circumstances prevailing at the time of the decision to incur costs was made. This subjective test of reasonableness provides great latitude for schools to include many items and services which might otherwise be excluded under the more specific Federal acquisition regulations. A cost allocable to a specific project if the goods or services are chargeable are assignable to such cost objectives in accordance with relative benefits received or other equitable relationship. Again, the non-specificity of A-21 provides discretion and indeed incentives to schools to define benefits received to their best advantage.

Do you agree with that statement, gentlemen?

Admiral **Miller**. I believe Mr. Kusserow has hit upon at least one of my own concerns—incentives for the universities to hold their own costs down—we really need to put something in the system that does that.

Mr. **Dingell**. And are clear and definable and understandable.

Admiral **Miller**. Yes, sir, and to simplify them.

Mr. **Dingell**. A set of instructions in the OMB records.

Admiral **Miller**. For example, with respect to the special studies, it says a special study may be done to support library costs or utilities or allocation of other areas, but the Government, has not defined what is an acceptable special study, so we get all sorts of studies put on the table. I think we ought to try and clarify that.

In the area of incentives, one incentive that is very strong on every university campus with which I am familiar is the faculty. The faculty are personally incentivized to hold down indirect costs. I believe that greater visibility by the faculty into the elements of indirect costs on campus would help. One way you could do that would be by separating the indirect costs into separate pools. For example, one that's administrative and one that's building costs. Then handle them differently to give greater visibility to what those rates are. The faculty, I would judge, would greatly support building-related costs that were put into renewal of the infrastructure, which is sorely needed in the country, and would tend to try and hold down what the university puts into the administrative side. There is an incentive that is self-governing.

The final piece that I would offer to you, sir, is I think the rates ought to be certain. The universities ought to know that there is going to be a Federal auditor coming in and looking over their books to ensure that the costs they have actually charged to the Government are allowable. That I believe needs to happen, and, in fact, that's why the Department of Defense has chosen the approach that we have.

Mr. DINGELL. They also need clear guidelines and clear instructions from the Office of Management and Budget and from the Government in connection with their contracting practices.

Admiral MILLER. Yes, sir, and Mr. Newton and I are working with that committee to review A-21 and to come up with new guidelines.

Mr. DINGELL. I salute you for that and I urge you to be diligent. A few auditors don't hurt, though, either, do they?

Admiral MILLER. Pardon me, sir?

Mr. DINGELL. I say a few auditors don't hurt either, do they?

Admiral MILLER. No, sir. In fact, that is why the DCAA and ONR together put forward that UCAP program, to get continued Federal audit presence on university campuses.

Mr. DINGELL. Now Admiral, the behavior of some of the officials of ONR was raised in questions at Stanford.

In the March hearing you informed the committee that you would be reviewing the matter and that you in fact had an ongoing review to determine what had happened and who was responsible. Can you give us the status of that review, if you please, Admiral?

Admiral MILLER. That review is in its final stages right now. They have interviewed over 29 witnesses, not only here in the Washington, DC. area, but in the leadership in DCAA, in Health and Human Services, at Stanford University, as well as our own internal people. I talked to the leader of that task force this morning by telephone.

I went outside of Washington, outside the system to get a leader. He has the whole team down in Mississippi at his laboratory, where they're in the last stages of writing the report and I anticipate that I will have it very shortly.

Mr. DINGELL. Would you keep the committee informed on that, please? When that review is completed, would you make a copy of it available to us, please?

Admiral **Miller**. Yes, sir, I will.

Mr. **Dingell**. Thank you. Now, Mr. Newton, a member of the subcommittee staff visited Cornell a week ago and found a situation which I find disturbing. In a quick look at just a couple of accounts, staff saw that there were thousands of dollars in liquor bills, private charter aircraft and purposes of Steuben glassware. Can you tell us what you know or what is your understanding of the situation at Cornell, please?

Mr. **Newton**. It's my understanding that at Cornell, there has been an internal screening of their overhead accounts and they have come forward with a proposal for reducing their accounts by $377,000. Again, this would be a reduction or a withdrawal voluntarily made, but to be——

Admiral **Miller**. Mr. Chairman, if I might add to that, additional charges that Cornell has offered to withdraw over the fiscal years 1986 to 1988 would bring the total to slightly over $1 million.

Mr. **Dingell**. Now, how far back does this go? Can you tell us, at Cornell, gentlemen, please?

Admiral **Miller**. 1986 to 1988 represent those years that are still open. We have to go back and audit the actuals, negotiate final rates and close them out. Prior to 1986, the accounts are all closed and those books are closed.

Mr. **Dingell**. OK. Now, gentlemen, in their defense, Cornell officials have implied that DCAA wasn't concerned about these types of charges and they inferred that they therefore should not include them. Can you tell us what is your understanding with regard to DCAA allowing Cornell to include these kinds of charges?

Mr. **Newton**. I'm not aware of anyone in DCAA that would condone those charges which are clearly unallowable as being acceptable.

Mr. **Dingell**. So, you've never given Cornell any reason to believe that these were not anything other than improper charges?

Mr. **Newton**. I have not seen any communication from DCAA that would confirm that.

Mr. **Dingell**. Now, Mr. Newton, at Cornell, officials say one part of their benefit package to the president includes the gift of the university home when the president retires. Have your auditors reviewed the components of Cornell's compensation of benefits planned, and what have you found?

Mr. **Newton**. That audit is another one which is ongoing. We are including that in the scope of our review and I will have to advise you of the results of it at the conclusion.

Mr. **Dingell**. Would the gift of a home be an item appropriate for inclusion in overhead accounts or indirect charges?

Mr. **Newton**. I would expect that it would not be; that it would be treated as an unallowable cost.

Mr. **Dingell**. And a gratuity?

Mr. **Newton**. Yes, sir.

Admiral **Miller**. I would argue, sir, that the cost of that house ought to be considered as housing provided to a university official. Under the new proposed revision to A-21 it would not be allowable. In fact, the gift of the house, I believe, would come under that also.

Mr. **Dingell**. Would it also be fair to infer that if the university wanted to be generous with their president on his retirement, that they should do it with their own money?

Admiral **Miller**. Yes, sir. We don't argue with the university's prerogative to spend their money how they would like, but we would not want that charged to us.

Mr. **Dingell**. Now, gentlemen, a number of accounts at Cornell, we note, have been withdrawn for funds named after donors who provided the money spent from the account. Now, even though these funds are donated and expended from the funds, they are still allocated to the Government. Is that proper?

Mr. **Newton**. An allocation of funds would not be proper and it should be unallowable.

Mr. **Dingell**. Now, let's take some examples. A public relations fund established by an anonymous donor contains funds for the sole purpose of constructing a new Cornell Club in New York City. Although all the money necessary to perform the construction projects has been donated up front, each time a project was undertaken, 30 percent of it was charged to organized research. Would these charges be proper to the Government?

Mr. **Newton**. Well, let me see if I can clarify the use of the donor funds and how they would relate to whether they would be allowable or unallowable. If the donor has just given the university an amount of money and the university has it in its funds and then uses that money to buy a research facility, then the depreciation of that research facility would be a university cost that would be allowable against our Government contracts. It's the use of the funds, whether there would be any beneficial or causal relationship to the Government which would be the driver on whether there would be any appropriate reimbursement.

Mr. **Dingell**. Now, Admiral Miller, you testified to some concerns at Columbia University. Would you want to elaborate on them, please, sir, for us?

Admiral **Miller**. The concerns I expressed with regard to Columbia were that Columbia had identified potentially unallowable costs in the amount of $163,000 for 1987 only. Potentially, these costs may have come into the later years. We're going to have to go back and look. I don't have specific examples of the components of that $163,000. That's what DCAA is going back and looking at.

Mr. **Dingell**. So you found them in 1987 and it wouldn't be unfair to assume that they occurred in 1988, 1989, 1990 and 1991?

Admiral **Miller**. Well, that would be a logical assumption and that's why we're going back to look, sir.

Mr. **Dingell**. Now, HHS told the committee, gentlemen, that based on their reviews, they thought that they had found about $14 million in questionable charges around the country. Can you give us some appreciation of what your total findings in terms of dollar amounts might be to date?

Admiral **Miller**. I don't think we have a final figure, sir. We're still in the process of auditing every school in DOD cognizance, and it's going to be some time before we have that figure.

Mr. **Dingell**. Now, can we exclude charges of being of such questionable character that they raise the possibility of fraud in all cases?

Admiral **Miller**. We have not seen any evidence of fraud, except—I will say again—except in that case which we discussed in your hearing on March 13 where there is an ongoing Naval Investigative Service investigation at Stanford. While we don't have any specific evidence of fraud, the amount unallowable is such that the NIS is continuing with that investigation. What we have done to assist them is to take all of those examples that were cited in your hearing by the General Accounting Office, as well as other witnesses, and done an analysis of why those charges are unallowable, in which years the costs occurred, and how much they were. We provided that analysis to the Naval Investigative Service to help their investigation. That investigation is still ongoing and I'm unable to comment further on it, sir.

Mr. **Dingell**. Gentlemen, we kept you here a long time. You've been of great assistance to the committee. We commend you for the vigor with which you are addressing the problem here. We look forward to working with you and we want you to know that you have the thanks of the committee as you leave us.

We thank you both, gentlemen, for the time and the energy and the effort that you have put into this matter. The committee stands adjourned until the call of the Chair.

[Whereupon, at 3:08 p.m., the hearing was adjourned.]

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